UNIVERSITY OF VIRGINIA
THE COLGATE DARDEN GRADUATE SCHOOL OF BUSINESS ADMINISTRATION
Tayloe Murphy Institute

Virginia Issues:

Reforming the Individual Income Tax

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and
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Taylor Murphy Institute

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FOREWORD

The Virginia individual income tax has been modified many times since its inception in 1843. However, there have been no major changes since 1972. With the current pressures to find additional sources of state revenue, it is an opportune time to review the existing tax. Our purpose is not to advocate a tax increase, but to suggest reforms, which could be adopted along with any changes to raise revenue. This study reviews the history of the tax, examines its current features, discusses the income tax systems of other states, and considers several options for change.

Reforming the Individual Income Tax is the sixth publication in the Tayloe Murphy Institute issue series. Earlier topics covered were the retail sales tax, indexing the individual income tax, local tax sharing, state aid to localities, and the local real property tax. The purpose of the issue series is to stimulate debate on topics of current interest in Virginia.

The authors of this study are Karen B. Bonventre, William T. Smith II, and myself. Ms. Bonventre and Mr. Smith are research assistants at the Economic Studies Center of the Tayloe Murphy Institute. As our list of acknowledgements makes clear, we had the benefit of comments and assistance from many persons.

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The authors take full responsibility for all conclusions and for any errors that remain despite our best efforts to avoid them.

John L. Knapp
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EXECUTIVE SUMMARY

This study examines the Virginia individual income tax from its inception to the present and considers several options for change. A broad history of the tax provides perspective on how the current structure has evolved. Features of the current tax are discussed, and five specific policy options, incorporating various approaches to tax reform, are analyzed. In addition, Virginia's income tax is compared with those of other states.

HISTORY OF THE VIRGINIA INCOME TAX

·Virginia has had an income tax since 1843. Throughout the 19th century the low rates and ineffective administration prevented it from being a major source of revenue.

·The modern income tax emerged as part of Governor Harry Byrd's sweeping reform of the state government in 1926. The structure of the current income tax is essentially that of 1926. The only major changes since that date have been:

1) an increase in rates in 1948;
2) the implementation of withholding in 1962;
3) the addition of an upper bracket; and
4) the adoption of conformity to federal adjusted gross income (AGI) in 1972.

·Since World War II the income tax has become an increasingly important source of revenue to the state. In 1945 the income tax represented 14.2 percent of total tax revenues; in 1982 the figure was 47.0 percent.

COMPARISONS OF STATE INCOME TAXES

Forty states and the District of Columbia impose broad based individual income taxes. Most states base their taxes on the federal Internal Revenue Code. Twenty-two states, including Virginia, use federal AGI as the starting point of their taxes.

·**Exemptions.**--All states with broad based income taxes, except Pennsylvania, allow personal exemptions or credits.

·**Standard Deduction.**--Virginia and twenty other states allow a standard deduction based on a percentage of AGI within limits. A flat standard deduction is used by thirteen states and seven do not permit a standard deduction.

·**Rates.**--Five states have flat rates, three apply a percentage to federal tax liability, and thirty-three, including Virginia, construct their own graduated rate structures.

·**Tax Burden**.--Broad measures of income tax burden indicate that Virginia's income tax burden in 1981 was greater than the national average. In contrast, the overall burden of state and local taxes, including taxes on property and sales, was below the national average.

STANDARDS OF EVALUATION

This study compares the current income tax and alternative policy options against the criteria of equity, efficiency, and ease of compliance and administration.

·An equitable tax varies the tax burden with ability to pay.

·An efficient tax creates minimal distortions in the market.

·The simplicity and convenience of taxpayer compliance and state administration must also be considered.

FEATURES OF THE CURRENT INCOME TAX

·**Tax Base**.--The tax base is equal to net income minus exemptions and deductions.

·**Definition of Net Income**.--Virginia conforms with several small modifications to the federal definition of AGI as a tax base.

·Federal AGI falls short of a comprehensive tax base, and hence can be criticized on both equity and efficiency grounds.

·Nonetheless, the benefits of simplicity and convenience that accrue to the state from conformity are substantial enough to outweigh the advantages of devising a more comprehensive base. For this reason, all of our options keep modified federal AGI as the starting point of Virginia's income tax.

·**Itemized Deductions**.--Personal deductions are expenses subtracted from AGI in arriving at taxable income. Taxpayers can choose between itemizing these various deductions or taking the standard deduction. Virginia conforms to federal itemized deductions, with a few adjustments.

·Arguments in favor of itemized deductions are that they:

1) help deal with special circumstances--such as catastrophic medical expenses or casualty losses which are not encompassed by income as a measure of ability to pay;

2) promote social goods, such as charitable donations;

3) adjust for costs of earning income, such as union dues and uniform rental.

·An objection to itemized deductions, such as those for home mortgage interest and charitable contributions, is that they are not appropriate in the computation of ability to pay, and hence result in understated taxable capacity for those who take them.

'Since the advantages of conformity are considerable, the choices for Virginia include either continuing to allow federal itemized deductions or not allowing any itemized deductions. Some of our options (3, 4, and 5) do the former, while others (options 1 and 2) do the latter.

'**Standard Deduction**.--While the federal government has abandoned the standard deduction in favor of a zero bracket amount (ZBA), Virginia's standard deduction is frozen at the federal level of 1974.

'There are a number of problems with the existing Virginia standard deduction:

1) Some taxpayers are eligible for itemized deductions less than the federal ZBA, but greater than the allowable Virginia standard deduction. Since they cannot itemize at the state level unless they itemize at the federal level, these taxpayers are penalized by being required to take the lower Virginia standard deduction.

2) Since the standard deduction has remained frozen while itemized deductions have been free to increase with inflation and economic growth, the relative advantage of those who itemize has increased.

3) The standard deduction incorporates a marriage penalty since both single taxpayers and married couples are subject to the same limits on the standard deduction.

'We propose raising the standard deduction to the level of the federal ZBA. This would reduce the marriage penalty, improve the relative position of those who take the standard deduction, and eliminate the penalty for those trapped between the Virginia standard deduction and the federal ZBA. Raising the level of the standard deduction would also improve Virginia's level of low income relief. Our options with itemized deductions (options 3, 4, and 5) incorporate this higher standard deduction.

'**Child and Dependent Care Deduction**.--Virginia allows a deduction for work-related child and dependent care expenses that can be taken in addition to either the standard or itemized deductions. It serves as an adjustment in arriving at net income, on the premise that child and dependent care expenses are costs of earning income.

'We eliminate this deduction in those options without deductions (options 1 and 2), and keep it for those with deductions (options 3, 4, and 5).

'**Personal Exemptions**.--Virginia permits personal, dependent, age, and blindness exemptions. An extra deduction is also allowed for the elderly.

'There are several problems with the exemptions as currently established:

1) They are too low to provide adequate poverty level relief.

2) The level of the personal and dependent exemption has remained unchanged since 1972. The historical rise in incomes has caused the fixed exemption to remove an even smaller portion of total

income from tax. Thus, the exemption is functioning less well as an adjustment for the varying taxpaying abilities of different size families with the same income. Our options resolve this difficulty by raising the level of the exemptions.

3) The equity of the special treatment for age and blindness is questionable since neither age nor blindness is by itself an indication of need. We propose eliminating these special exemptions and have excluded them from our options.

4) In combination with graduated rates, fixed exemptions provide greater relief to high income taxpayers than to those with lower incomes. This occurs because the value of a fixed exemption increases with a taxpayer's marginal rate (the rate applied to the last dollar earned). To equalize tax relief, all of our options with graduated rates (options 2, 4, and 5) use credit amounts subtracted from tax liability in place of exemptions. The value of the credit is set equal to the level of an exemption times the rate of the lowest bracket.

·**Poverty Floor.**--The current Virginia income tax does not provide adequate tax relief for households with incomes below the poverty threshold. We suggest raising the minimum taxable level closer to federal poverty thresholds for different size households. For options with itemized deductions (options 3, 4, and 5), poverty relief is divided between increased standard deductions and an increased per person exemption (or credit equivalent). For options without personal deductions (options 1 and 2), poverty relief is provided solely through exemptions (or credit equivalents).

·**Rate Structure.**--Rates are applied to Virginia taxable income, which is equal to modified federal AGI minus exemptions and deductions. The rate schedule can be defined as the marginal rates that apply to successive strata of income. The current Virginia rate structure is graduated, so that marginal rates increase with income. Proposed reforms of the Virginia rate structure range from broadening its brackets to changing to a flat rate tax. Some critics consider graduated rates unfair and note a number of problems that arise from their use:

1) Graduated rates are associated with complicated tax codes. Such complexity results not so much from the actual application of graduated rates when computing tax liability (an arithmetic exercise that requires minimal effort), but from attempts to deal fairly with issues such as the treatment of the timing of income and the family unit.

2) It is also charged that high marginal rates cause inefficiencies. Incentives to work, save, and invest may be reduced because of the smaller after-tax return from these activities. In addition, the quest for loopholes and tax shelters is accelerated with high rates since it becomes more profitable to shelter income from tax as the tax bite gets larger.

3) Critics point out that graduated rates penalize taxpayers during times of inflation because of "bracket creep." Inflation increases taxpayers' nominal incomes pushing them into higher brackets.

•Supporters of graduated rates respond that:

1) The detrimental effects of graduated rates are most noticeable under a steeply graduated structure with high marginal rates. The Virginia tax is graduated only at the lower end of the income distribution, and at relatively low rates.

2) Most work, saving, and investment decisions are influenced by the federal income tax provisions rather than the state income tax provisions because of the significantly greater federal tax burden.

3) A graduated income tax is an effective and equitable instrument of income redistribution.

•A flat rate is supported by some analysts because it eliminates many of the disadvantages of graduated rates:

1) A flat rate would reduce the need for complexities resulting from highly graduated rates.

2) Implementation of a flat rate tax would reduce disincentives to work, save, and invest for those taxpayers whose marginal rate would fall. This salutory effect would be limited, however, because a new flat rate tax would decrease the marginal rate for some and increase it for others in order to raise the same revenue as the existing graduated structure. While disincentives would be reduced for those with declining marginal rates, disincentives would increase for those with rising marginal rates.

3) Bracket creep resulting from inflation would be eliminated since there would be no brackets.

4) Some feel that a flat rate satisfies the criterion of ability to pay since it requires higher income taxpayers to pay more tax in absolute amounts than lower income taxpayers.

•Other analysts oppose a flat rate tax because:

1) They feel it is unfair that higher income individuals are subject to the same tax as those with lower incomes;

2) Many work, saving, and investment disincentives arise from the level of the marginal rate, rather than from the graduation;

3) Enactment of a flat rate tax to replace a graduated rate structure would probably increase the burden on middle income taxpayers.

·Our proposals use different types of rate structures. Two options (1 and 3) use a flat rate; two options (2 and 4) have broad brackets based upon an approximation of the quartile distribution of taxable income. The remaining option (5) only slightly modifies the existing rate structure. The actual rates set in our options were generated under the assumption of differential incidence; that is, they were set at levels that would yield approximately the same revenue as the existing tax. This approach allows us to attribute changes in the tax burden solely to features of the options.

ALTERNATIVE TAX OPTIONS

·Option 1 is a flat rate applied over an exempted amount with no deductions.

·Option 2 is similar to option 1 in that there are no deductions. The flat rate, however, is replaced by a graduated rate structure. Credits replace exemptions in order to equalize tax relief. Brackets are set to approximate the quartile distribution of taxable income.

·Option 3 has a flat rate, but in contrast to option 1, allows deductions. Provisions for low income relief are divided between the standard deduction and the personal and dependent exemptions. The standard deduction is based on the level of the federal ZBAs.

·Option 4 is similar to option 3 in that it allows deductions. The flat rate, however, is replaced by a graduated rate structure. As in option 2, credits replace exemptions. The standard deductions are the same as in option 3. Brackets are based on an approximation of the quartile distribution of taxable income.

·Option 5 is a modification of the current Virginia income tax. The existing brackets are used, but the rates are slightly higher. Deductions are allowed. Poverty level tax relief is provided through increased standard deductions and credits. The standard deduction is equal to the federal ZBA. Credits are used instead of exemptions to equalize tax savings.

.A flat tax rate plan has been proposed by Delegate Johnny S. Joannou. His proposal calls for eliminating deductions, allowing a large exemption and applying a flat rate. It is similar to our option 1 except for the exemptions.

ANALYSIS OF THE OPTIONS

The distribution of the tax burden under the alternative policy options is examined using:

1) average tax liability by AGI class as generated by the Virginia Department of Taxation's simulation model,

2) tax liability of hypothetical households at income levels ranging from $7,500 to $100,000 and with household size varying from one to six members.

•According to both measures all the options, even those with flat rates, are progressive--that is, the percentage of income paid as tax rises with income. While this percentage (known as the effective tax rate) increases with income in all options, it rises more rapidly in the graduated tax options than in the flat rate options.

•All of the options impose a lower tax burden on taxpayers with poverty level income than does the current system, with the exception of single taxpayers in option 1.

•All of the options, except option 1, reduce the burden of the lowest AGI class, although the graduated rate options generally provide the greatest relief.

•The flat rate proposals (1, 3, and Joannou) raise taxes for middle income taxpayers while reducing taxes for those with higher incomes.

•The graduated tax proposals (2, 4, and 5) reduce the burden of lower income taxpayers, while increasing it for higher income taxpayers.

•The flat rate options increase the burden of low and moderate income single taxpayers relative to the current system. Married couples earning between $15,000 and $25,000 would also pay more tax. Generally, all other hypothetical taxpayers have a reduced burden under the flat tax options.

•The Joannou proposal increases the tax burden for middle income individuals and large families and decreases the burden for all others.

•The graduated rate options (2, 4, and 5) reduce the tax burden for lower income taxpayers and raise it for upper income taxpayers, regardless of family size.

OTHER POSSIBLE REFORMS

This study presents a number of additional suggestions.

•**Indexation.** During periods of inflation, the real value of fixed exemptions, deductions, and credits declines, while inflated nominal incomes push more people into higher marginal tax brackets. This means tax liability can increase for taxpayers whose real income remains the same. To prevent distortions caused by inflation we recommend indexing all fixed dollar exemptions, credits, standard deductions, and brackets.

•**Minimum Tax.** The minimum tax is an indirect way to increase the comprehensiveness of the tax base. The federal government adopted a minimum and alternative minimum tax to ensure that at least some of the tax is paid by those who benefit from tax preferences. Since Virginia depends on federal AGI as its tax base, it seems reasonable for the state to also adopt federal base broadening provisions. We recommend that Virginia follow the practice of a few other states and tax a percentage of the federal minimum tax.

·**Age Credit.** Virginia provides a credit for taxpayers age 62 and over in order to address the inequities resulting from the exclusion of Social Security and railroad retirement benefits from the tax base. It is a vanishing credit, decreasing for AGI over $12,000. This upper income constraint results in considerable complexity and causes inequities among elderly upper income taxpayers with different sources of income. We recommend raising or eliminating the $12,000 income constraint.

·**Local Income Tax.** If a local income tax is desired, we suggest the use of a piggyback tax on the state income tax, using state collection and administration, and exempting non-residents who work in the locality. In comparison to a local payroll tax, this would reduce administrative costs and complexities for the taxpayer and the locality.

FINAL COMMENT

The options presented in this study are designed to aid policymakers by illustrating various approaches to income tax reform. For analytical convenience, rates for our policy options have been selected so as to raise the existing amount of income tax revenues. Practically, however, we recognize that it will probably be the need for increased state revenues, rather than any abstract sense of the need for reform, that will focus attention upon the Virginia income tax. If increased revenues are desired, we suggest raising the rates of our options, rather than altering their underlying structures which have been designed to promote the equity, efficiency, and simplicity of the tax. We hope that any search for revenues will provide an opportunity to implement tax reforms such as those presented here.

CHAPTER 1
INTRODUCTION

Virginia, which first adopted an income tax in 1843, has one of the oldest, continuously functioning, state individual income taxes in the nation. The tax is currently the largest source of state tax revenue, raising $1.6 billion in fiscal year 1983. This study examines the tax from its early days to the present and considers several options for change. Reforms discussed include raising the level of low income tax relief and changing the rate structure by broadening the brackets or adopting a flat rate.

Chapter 2 provides a detailed history of the income tax, divided for convenience into three phases. The first phase embraces the period from the inception of the tax in 1843 to the end of the Civil War. The second phase begins with the Virginia Constitution of 1870 and ends with the tax reform movement of the Progressive Era. The final phase encompasses the modern history of the tax, from the Byrd reforms of 1926 to the present day. This broad historical background provides perspective on why the tax has taken its present form.

Chapter 3 considers the standards for evaluating tax policy--equity, efficiency, and simplicity. An equitable tax is considered to be one that varies the tax burden in accordance with ability to pay, while economic efficiency calls for a tax that creates minimal distortions in the market.

Chapter 4 analyzes the principal characteristics of the current Virginia income tax, including the definition of income; the provision and rationale of exemptions, deductions, and credits; and the size of tax rates and brackets. As these features are discussed, problems with them are highlighted and various ways of dealing with them are considered.

In Chapter 5 the income tax systems of the states with broad-based income taxes are compared. As has often been noted, the American federal system provides a laboratory for experimentation. The tax systems of other states furnish a wealth of information on how these states have handled their revenue needs and the resulting tax burdens imposed on their citizenry. In regard to burden, the experience of nearby states is particularly important because of regional competition for industry.

In the concluding chapter several tax packages incorporating different approaches to tax reform are proposed and considered. These policy options are designed to raise approximately the same revenue as the existing tax. This differential incidence approach allows us to compare the distribution of the tax burden among our options and the existing tax system. This is done by computer simulations of the options and by computing the tax liability of hypothetical taxpayers.

Before undertaking this review, it is helpful to briefly mention the current provisions of the Virginia individual income tax. The tax uses a base of federal adjusted gross income (AGI) with modifications and allows most federal itemized deductions or a standard deduction of 15 percent of AGI with a minimum of $1,300 and a maximum of $2,000 for single individuals and married couples. Virginia permits a $600 personal, dependent, age, and blindness exemption plus an additional $400 exemption for the elderly. Also provided are a child and dependent care deduction and an age credit. There is one graduated rate schedule, applied to all taxpayers. The current rate schedule is:

Taxable Income	Rate
0 to $ 2,999	2%
$ 3,000 to $ 4,999	3%
$ 5,000 to $11,999	5%
$12,000 and over	5.75%

Each income earner of a married couple may compute his or her tax separately. Keeping in mind the provisions of the existing tax will be useful as we consider the historical development of the tax and discuss various reforms.

CHAPTER 2

HISTORY OF THE VIRGINIA INCOME TAX

The State of Virginia has used an income tax continuously since 1843. This fact is worth a footnote in the annals of American public finance, since it makes the Virginia income tax one of the oldest, continuously functioning, state income taxes in the country.[1/] Several states experimented sporadically with income taxes in the mid-19th century, but most of these early efforts were short-lived. The modern resurgence of state income taxes began only after the success of the Wisconsin income tax of 1911.[2/]

The history of the Virginia income tax is as confused as it is venerable. One observer, writing in 1903, described it as "the history of a confused mass of legislation."[3/] Another writer noted caustically that in its tortuous evolution the income tax had undergone "nearly every imaginable variation."[4/] Our purpose here is merely to trace the outlines of this history; it will be convenient as well as enlightening to do so by discussing several distinct stages in the evolution of the tax.

Early History: 1843-1871

Growth and the Planter Aristocracy (1843-1850)

Like most other states in the late 1830s, Virginia began an extensive program to expand its network of railroads, canals, and turnpikes. Virginia needed to improve these modes of transportation because she lay astride the natural artery between the northern and southern states. As western Virginia developed, an east-west axis emerged as well. Though temporarily frozen by the Depression of 1839-1844, the building program was reinstituted as soon as financial conditions began to improve. Most of the funds for the program were

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1/ Walter M. Heller and Clara Penniman, State Income Tax Administration (Chicago: Public Administration Service, 1959), pp. 3-4. The "faculty" taxes of the colonies are often construed as income taxes. In fact, these taxes were an effort to tax personal ability rather than a tax on actual income. See Edwin Seligman, "Colonial and State Income Taxes," Political Science Quarterly X (June 1895), p. 247 and Delos Oscar Kinsman, The Income Tax in the Commonweaiths of the United States (New York: MacMillian Company, 1903), pp. 1-16.

2/ Heller and Penniman, p. 6.

3/ Kinsman, Income Tax, p. 37.

4/ Kossuth Kent Kennan, Income Taxation (Milwaukee, Wisconsin: Burdick and Allen, Publishers, 1910), p. 232.

borrowed,[1] but as an ancillary measure to increase revenue, an income tax was instituted in 1843.[2]

The political evolution of this tax is rather interesting. Prior to 1843 the major sources of state revenue included taxes on land, houses, lots, and certain forms of personal property; a poll tax; and a license tax.[3] The income tax was designed to shift the tax burden of the building program away from the propertied classes and plantation aristocracy of the east coast who controlled the legislature, to the non-propertied class of wage earners and to the owners of industrial capital.[4] Thus the tax was set at 1 percent on all wage income greater than $400 (professionals such as lawyers, doctors and dentists, could alternatively pay a fixed license fee) and 2.5 percent of interest income from securities, bonds, or notes of value greater than $100.[5]

The imposition of the income tax was a recognition of the growing role of wage-earners and capitalists in the agricultural economy of the Old South. However, this growing economic power also had political repercussions.[6] Capitalists lobbied against the income tax, with the result that in 1844 the tax on interest was lowered to 2 percent and the value of assets exempted from the tax on interest was increased from $100 to $6,000.[7]

Progressive Taxes (1851-1860)

Virginia adopted a new state Constitution in 1851. This Constitution specifically granted the General Assembly the power to tax incomes, but added the caveat that the property from which that income was derived could not be taxed.[8] An income tax law was enacted in 1852 and the earlier proportional rate structure was abandoned in favor of a progressive one. Income derived from personal services was taxed according to the schedule:

1/ Benjamin Ulysess Ratchford, American State Debts (Durham, N.C.: Duke University Press, 1941), p. 124.

2/ National Industrial Conference Board, State Income Taxes, vol. I: Historical Development (New York: National Industrial Conference Board, 1930), p. 19.

3/ Kinsman, Income Tax, p. 37.

4/ Edgar Sydenstricker, A Brief History of Taxation in Virginia (Richmond: Legislative Reference Bureau, 1915), p. 49.

5/ Kinsman, Income Tax, p. 38.

6/ Sydenstricker, p. 50.

7/ Kinsman, Income Tax, p. 39.

8/ National Industrial Conference Board, p. 20.

Taxable Income	Tax Rate
0 to $ 99	0.0%
$100 to $249	0.25%
$250 to $499	0.50%
$500 to $999	0.75%
$1,000 and over	1.00%

Doctors and dentists were required to pay a fixed license fee and a progressive income tax:

Taxable Income	Tax Rate
0 to $399	0.0%
$400 to $599	0.50%
$600 to $999	0.75%
$1,000 and over	1.00%

Complete exemptions were granted to "laborers engaged in the mechanical arts, trade, handicraft, or manufacture"[1] and the tax on interest income was made less general.[2]

In 1856, all progressive rates on salaries and interest were doubled, leading to a tremendous increase in revenue.[3] The progressive tax on doctors and dentists, however, was dropped in favor of a flat rate of 0.5 percent on incomes over $400, plus the license fee; this was also applied to lawyers.[4]

Civil War (1861-1865)

Most of the financial burden of the Civil War lay directly on the state governments rather than on the Confederate government. To a large extent this burden was met by bond sales, money creation, and so-called "cotton notes," but most southern states made little attempt, until late in the war, to increase tax revenues. Virginia was an exception, consciously raising taxes to meet wartime exigencies.[5]

Rather than resort to a general property tax, as did many northern states, Virginia relied upon her income tax for two reasons: 1) Virginia did not have an existing, well developed property tax,[6] and 2) there was a general sense that the propertied classes should not bear the entire burden of the war effort.[7]

1/ National Industrial Conference Board, p. 20.

2/ Kinsman, Income Tax, p. 41.

3/ Ibid., p. 56.

4/ Ibid., p. 43.

5/ For an overview of the complexities of Confederate war finances, see Ratchford, pp. 141-61.

6/ National Industrial Conference Board, p. 20.

7/ Edwin Robert Seligman, The Income Tax (New York: MacMillian Company, 1911), p. 406.

In 1861 the progressive tax on salaries and fees was repealed and replaced by a proportionate rate of 1 percent on income greater than $500. In 1862 this rate was increased to 1.5 percent, while the rates on interest from bonds and income from toll-bridges and ferries were raised to 10 percent.[1] As a result of these changes, revenue increased by more than 50 percent.

Up to this point, changes in the income tax were limited to rates and not structure. It should be emphasized that the structure of the income tax until 1863 was not that of the general income tax with which we are familiar. The early income tax was rather a tax on specific sources of income such as salaries and interest.[2]

By 1863, however, the financial situation was bleak. In a reform which in retrospect seems revolutionary, Virginia revised the structure of its income tax to include a general tax on income. A specific tax (at a higher rate of 2.5 percent) remained in effect on salaries and fees, while a new tax of 10 percent was levied on:

> ...[all income] received by any person from any licensed trade, business, or occupation, from the use of money by others for the benefit of the owner, from buying and selling, from the exchange of real or personal property or of bonds, stocks, or other choses in action, and from any other trade or speculation.[3]

To prevent double taxation, individuals paying taxes on specific sources of income were exempted from the general income tax. At the same time the rates on interest from bonds and income from toll-bridges and ferries were raised to 17 percent.

By this time, inflation was rampant. Combined with the higher tax rates on nominal income, this yielded "fabulously high revenues."[4] Most of these gains were illusory, however. As Benjamin Ratchford observes more generally about southern taxes, "...the new taxes increased nominal receipts, but not in proportion to the decline in the value of the currency."[5] An indication of the degree of depreciation of the currency was the growth of the nominal base exemption, which was raised from $400 to $3,000.[6]

1/ Kinsman, Income Tax, pp. 44-45.

2/ Seligman, Income Tax, p. 403.

3/ Kinsman, Income Tax, pp. 44-45.

4/ William Stauffer, Taxation in Virginia (New York: The Century Co., for the Institute of Research in the Social Sciences, University of Virginia, 1931), p. 100.

5/ Ratchford, p. 159.

6/ National Industrial Conference Board, p. 21.

Reconstruction (1866-1871)

The legislature elected by vanquished Virginians in 1865 was dominated by "old time Whigs."[1] These men were staunchly conservative, but had opposed secession, and their election bespoke a general willingness on the part of Virginians to accept the verdict of the war.[2] One of the responsibilities of this moderate assembly was to put the disrupted state finances back into order. Thus, in 1866 the entire tax structure was overhauled. Objects of taxation were listed according to five schedules, A through E. Schedule A covered the poll tax. Schedules B and C constituted a general property tax, Schedule D an income tax, and Schedule E a tax on salaries. Schedule D, in turn, classified income according to six different sources, each of which was taxed at its own rate. Rates for these six classes were flat and varied between 0.5 and 3 percent.[3] Salaries were also taxed at a separate rate. This complex system was almost impossible to enforce,[4] and revenues fell to the lowest levels since the mid-1840s[5] (see Table 2.1). Rates were increased across the board in 1867.[6]

The policy of conciliation was short-lived in Virginia. As the radicals wrested control of the Virginia Republican party from their more moderate compatriots, there was a concomitant shift towards a more extreme position by conservative Virginians (both Democrats and Whigs). In December 1866 the General Assembly refused to ratify the 14th amendment.[7] In March 1867 the U.S. Congress responded by passing the Reconstruction Acts, and Virginia became part of Military District Number One.[8]

1/ Quoted from the National Intelligencer by Hamilton James Eckenrode, The Political History of Virginia During Reconstruction (Baltimore: John Hopkins Press, 1904), p. 41.

2/ For a discussion of the conciliatory attitude of the General Assembly, and of most Virginians, through 1866 see James Douglas Smith, "Virginia During Reconstruction, 1865-1870--A Political, Economic and Social Study" (Ph.D. Dissertation, University of Virginia, 1960), pp. 17-33.

3/ Kinsman, Income Tax, p. 46. The six classes of income under schedule D were: 1) income from interest or profit of public corporations; 2) income from companies incorporated by the state, but which did not pay taxes to the state; 3) income from interest or profit from companies chartered outside the state, or from companies chartered inside the state but doing business outside; 4) income in excess of $500 per year derived from licensed businesses, unless the license tax was based upon sales, receipts, or profits; 5) income in excess of $500 from trade or speculation; 6) income in excess of $500 from fees of office.

4/ Kennan, p. 233.

5/ Kinsman, Income Tax, pp. 56, 124.

6/ The structure of the tax in this period was strikingly similar to that of the English war income tax, as revised by the Act of 1803. Compare with Seligman's description of the Act of 1803, Income Tax, pp. 92-98, or Kennan, pp. 58-79.

7/ Smith, p. 30.

8/ Ibid., p. 38.

TABLE 2.1

VIRGINIA INCOME TAX REVENUES, 1844-1929

Year	Revenue	Year	Revenue
1844	$ 16,719	1895	$ 43,026
1845	16,617	1896	42,378
		1897	37,502
1847	16,590	1898	43,205
		1899	54,148
1851	23,307	1900	46,024
		1901	59,252
1853	36,304	1902	60,357
		1903	64,781
1855	31,694	1904	70,945
		1905	77,414
1858	99,481	1906	94,291
		1907	122,057
1860	104,517	1908	102,811
		1909	106,909
1863	178,945	1910	134,562
1866	23,000	1913	164,136
1869	60,079	1917	642,549
		1918	938,008
1874	37,696	1919	1,738,223
		1920	2,210,525
1879	29,432	1921	2,264,793
		1922	1,150,117
1887	38,951	1923	1,571,509
1888	38,145	1924	1,738,254
1889	45,907	1925	1,710,053
1890	51,246	1926	3,495,927
1891	62,207	1927	3,724,021
1892	54,154	1928	4,141,804
1893	51,700	1929	4,549,542
1894	40,943		

Sources: (1844, 1860, 1866) Kinsman, Income Tax, pp. 55-56; (1845, 1853, 1858, 1863, 1869, 1874, 1879) Kinsman, Income Tax, p. 124; (1847, 1851, 1855) Syndenstricker, History of Taxation in Virginia, p. 50; (1877-1908) Kennan Income Taxation, p. 235; and (1910-1912) Alzada Comstock, Studies in History, Economics and Public Law, vol. 101: State Taxation of Personal Incomes (New York: Longmans, Green and Co., 1922), p. 95; (1901-1910) Seligman, The Income Tax, p. 451; (1913,1917-1929) Stauffer, Taxation in Virginia, p. 102.

With this tempestuous overture, it is not surprising that the issue in the elections for the delegates of the upcoming constitutional convention should be clearly drawn: "white conservatism v. Negro-Radical dominance."[1] In the event, the Radicals swept the polls. The new Constitution, despite a small body of determined Conservatives,[2] was to be the creation of the Radical Republicans.

The new Constitution was a benchmark in the history of the income tax. The legislature was expressly given the power to tax incomes in excess of $600[3], and the earlier prohibition against taxing the property from which income derived was abolished. "This provision," notes one observer, "gave more latitude to the Virginia Assembly than any previous Constitution."[4] This open-ended clause seems to have been part of a general effort by the Radicals to shift the tax burden away from blacks and poor whites and towards the propertied and monied classes.[5]

In June 1870 the General Assembly exercised its new constitutional prerogative. A new law was promulgated to include rent in the definition of income. The system of five schedules was retained, but the subdivision of Schedule D regarding income was abandoned in favor of a flat rate of 2.5 percent on all types of income. In 1871 the rate was reduced to 0.5 percent.[6] This rather drastic cut might been have related to the re-entry of ante-bellum leaders into politics, and to the increased legislative majority of the Conservatives after the elections of 1871.[7]

Middle History: 1872-1925

After 1871 there were no significant changes in the tax until 1926. Minor changes were made from time to time in the level of the exemption or in the definition of income. But in its essentials, the tax structure defined in the legislation of 1871 was to stand for more than fifty years. A summary of some of the legislative changes which did occur is presented in Table 2.2.

1/ Smith, p. 61.

2/ Ibid., p. 62.

3/ Virginia, Constitution (1870), Article 10, Section 4.

4/ National Industrial Conference Board, p. 21.

5/ This at least is the way the Conservatives saw the tax provisions of the Constitution. See Smith, p. 109. See also, Charles Chilton Pearson, The Readjuster Movement in Virginia (New Haven: Yale University Press, 1917), p. 18.

6/ Kinsman, Income Tax, pp. 51-52.

7/ This is conjecture on our part. A cursory review of legislation and politics 1870-1871 can be found in Richard L. Morton, History of Virginia, vol. III: Virginia Since 1861 (Chicago: The American Historical Society, 1924) pp. 164-65.

TABLE 2.2
CHANGES IN INCOME TAX RATES
AND EXEMPTIONS, 1870-1916

Year	Exemptions	Rate
1870	$1,500 + $1,500 per dependent	2.5%
1871	$1,000 per family + $1,000 for a ward	0.5%
1872	$1,000	1.0%
1874	$600 per family + $600 for a ward	1.0%
1889	$600	1.0%
1908	$1,000	1.0%
1910	$2,000	1.0%
1916	$1,200	1.0%

Sources: (1870-1889) abstracted from Kinsman, Income Tax, pp. 5-55; (1908-1916) National Industrial Conference Board, State Income Taxes, vol. I: Historical Development, pp. 21-22; (Dependent exemptions 1870-1901) Robert Clinton Burton, "The History of Taxation in Virginia," (Ph.D. dissertation, University of Virginia, 1962), p. 79.

Although there were no significant changes in the income tax after 1871 until 1926, events during this period did affect the evolution of the tax. Reform movements brought to the public's attention ideas for changing the structure of the income tax.

Legislative Inertia (1872-1901)

The dearth of legislated changes during this time belies the importance of the last third of the 19th century in the development of the income tax. This period saw a series of challenges to the conservative power structure by reformist parties which drew their inspiration from the abortive reforms of radical reconstruction. These reformist parties included the Readjusters, who endorsed

the concept of taxation by ability to pay,[1] and the Populists, who in 1893 called for a graduated state income tax.[2] These concepts were not accepted by the conservatives. Instead, conservative legislatures turned their backs to the redistributive intent of the taxing provisions of the state Constitution. Far from trying to make the tax system more progressive, the conservatives actually tried to make it more regressive. Because the income tax fell upon the upper classes, it was ignored as a significant source of revenue. The advocacy of a graduated income tax by the reformist parties which challenged the conservatives resulted in the proposal taking on something of a revolutionary flavor. It was therefore frowned upon for ideological reasons.

After bitter struggle and much compromise, the conservatives, who with the old Whigs formed the new Virginia Democratic Party, succeeded in consolidating their control of the state.[3] The course of this struggle, and its ultimate outcome, conditioned the growth of the income tax in the 20th century.

The Impetus for Reform (1902-1925)

By the beginning of the 20th century there developed a growing popular disenchantment with the tax system in general. This disenchantment was reflected in a movement for tax reform which gained momentum through the first quarter of the 20th century. The income tax was at first an ancillary object of reform, a politically palatable source of new revenues with which to finance a general overhaul of the tax system. Slowly but surely the income tax shook off the inertia which had governed its course for fifty years to enter, albeit through the back door, into the mainstream of Virginia finances.

Progressivism.--In 1909 Oscar Kinsman noted the flurry of "income tax activity" which had occurred in many states since about 1895. This activity included considerations of adopting an income tax in states that did not have one and reforming the tax in the states that did. He attributed this burgeoning interest in the income tax to the fundamental reorientation of popular attitudes which has come to be known as the Progressive Movement:

> This movement would scarcely leave untouched the subject of taxation, where injustice is so common. The people have turned to an income tax because they believe in the theory

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1/ Pearson, pp. 176-77. See also Raymond N. Pulley, "Old Virginia Restored: An Interpretation of the Progressive Impulse" (Ph.D. dissertation, University of Virginia, 1966), p. 53. Thomas Jefferson had advocated ability to pay taxation in 1785: "Another means of silently lessening the unequality of property is to exempt all from taxation below a certain point, and to tax the higher proportions of property in geometrical progression as they rise." Letter to Madison, 28 October 1785, quoted by Dumas Malone Jefferson and His Time, vol. II: Jefferson and the Rights of Man (Boston: Little, Brown and Co., 1951), p. 129.

2/ Virginius Dabney, Virginia: A History from 160/ to the Present (Garden City, N.Y.: Doubleday, 1971), p. 423.

3/ For a lucid and readable account of this see Allen W. Moger, Virginia: Bourbounism to Byrd, 1870-1925. (Charlottesville: University Press of Virginia, 1968).

> that individuals should contribute to the support of the government according to ability, and that income is the most just measure of that ability.[1]

Virginia had a long tradition of reformist agitation. However, in the words of an historian, "It would be a mistake...to assume that the progressive impulse of the early twentieth century was a direct descendent of the reform agitation of the previous decades."[2] The reform movements of the 19th century had advocated to a greater or lesser degree the leveling of Virginia's social and economic strata. They had therefore operated beyond the pale of, and were threats to, the traditionalist Democratic power structure. The Progressive movement in Virginia, however, developed within that structure; it was:

> ...a reactionary rather than a liberal movement. The reforms undertaken in the state during the progressive era were designed more to conserve and strengthen the Old Virginia order than to rid the state of political bosses and broaden the base of popular government.[3]

The importance of the reform movements of the 19th century thus lies not in their actual accomplishments, but rather in the response they elicited from the Old Guard. During the last quarter of the century there was a running battle by conservatives for mastery of the state. The ultimate triumph of the conservatives was insured by, and embodied in, the Constitution of 1902 which reduced the size of the electorate and disenfranchised many blacks and poor whites.[4]

With its position secure in conditions that approached the status quo ante-bellum, the Democratic Party organization now paternalistically sanctioned a host of reforms.[5] The choice of this course was due partially to the Democratic leadership's traditional sense of noblesse oblige.[6] To a large extent, however,

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1/ Oscar Delos Kinsman, "The Present Period of Income Tax Activity in the American States," Quarterly Journal of Economics 23 (February 1909), pp. 296-97.

2/ Pulley, p. 143. Pulley builds upon a 'revisionist' approach to the Progressive Era, which sees Progressivism as a conservative rather then liberal phenomenon. The seminal works of this interpretation are George E. Mowry, The California Progressives (New York: Knopf, 1955) and Richard Hofstader, The Age of Reform: From Bryan to F.D.R. (N.Y.: Quadrangle/ New York Times Book Co., 1961).

3/ Pulley, p. 33.

4/ Ibid., pp. 23-24.

5/ For a discussion of reforms during the period 1903-1911, such as those in education, public health, roads, see Dabney, chapter 34.

6/ Pulley, p. 202.

the advocacy of reform was simply good political horsesense. The times were changing, and one of the secrets of the success of the party organization was "...its capacity for acceding to popular demands for more and better services just in time to prevent a popular revolt."[1/]

Thus, although there had long been an impetus to reform, Progressivism came to Virginia only after 1902. Before that year, and until the Democratic "machine" held securely the reins of power, reform was inconceivable.

The Constitution of 1902.--The new Constitution made no changes in the tax structure, but it did give the legislature power to change the revenue laws at its discretion.[2/] In particular, it provided that:

> ...nothing in this Constitution shall prevent the General Assembly...from segregating for the purposes of taxation the several kinds of classes of property, so as to specify and determine upon what subjects state taxes, and upon what subjects local taxes, may be levied.[3/]

This was the origin of the so-called "segregation" or "separation" debate which bedeviled Virginia politics until 1926. Since the evolution of the income tax became inextricably tied to the institution of separation, we must pause to investigate the question more deeply.

The issue was essentially whether the taxing powers of the state and local governments should be separated--the local governments deriving revenue solely from "tangible" property such as real estate and the state government in turn relying upon taxes on "intangible" property such as insurance, fees, licenses, and inheritances.

The issue arose because originally all direct taxation was local in character,[4/] so that localities received the benefits of the taxes imposed upon them. The growth of general purpose state expenditures, however, led to the imposition of state property taxes on top of the local. This naturally led to geographical inequities. The growing cities of Virginia received more and more of the benefits of taxation (especially educational appropriations which were allocated in proportion to population), while rural counties carried more and more of the burden.[5/] These geographical inequities were exacerbated by the fact that assessments were carried out by the localities themselves. Local

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1/ Dabney, p. 458.

2/ Thomas Walker Page, "The Movement for Tax Reform in Virginia," Journal of Political Economy 24, no. 8 (October 1916), p. 738.

3/ Virginia, Constitution (1902), Article XII, Section 169.

4/ Edwin Seligman, "The Separation of State and Local Revenues," in State and Local Taxation (Norwood, Mass.: National Tax Association, 1970), p. 487.

5/ Page, p. 739.

officials would deliberately underassess, then increase the local rates.[1] Thus, the local government could keep the same level of local revenues while reducing the amount local property owners would owe the state. Furthermore, there was an incentive for "competitive underassessment,"[2] as landowners in one county cast envious glances at lower assessments in neighboring counties.[3]

Economists such as Edwin Seligman advocated the separation of state and local revenues as a solution to these problems, for several reasons. First, it would remove the incentive for competitive underassessment. Second, it would remove the burden of double taxation from landowners, in particular the small farmers. Finally, it would check the nascent conflict of interests between urban and rural localities.[4]

The arguments against separation were practical, rather than theoretical, including a possible loss of revenue to localities[5] and a definite and sizable loss in revenue to the state. This would prove to be the key to the development of the income tax. One of the major reasons for the later expansion of the income tax was precisely the need to offset the decrease in revenues resulting from separation.

At the Constitutional Convention of 1902, there was general recognition of the need for tax reform. Tax revenues were small, however, and the obvious inequities not very pressing. The result was that, while the General Assembly was given the power to separate taxes, it was forbidden to do so for a period of ten years after the adoption of the Constitution.[6] Thus tax reform was effectively put on ice for another decade.

The Tax Commission of 1910.--In 1910, anticipating the termination of the constitutional constraint, the General Assembly created a Tax Commission to report on possible reforms, with specific attention to separation. The Commission published its report in 1911. Separation, it argued, was theoretically desirable, but infeasible in practice.[7] The essential reform, it said, was not separation *per se*, but rather the institution of a permanent Tax Commission with the power to equalize property assessments and dismiss incompetent or venal assessors.[8]

1/ Douglas S. Freeman, "Tax Conditions in Virginia," in State and Local Taxation (Columbus, Ohio: National Tax Association, 1912), p. 69.

2/ A phrase used by Harry Byrd, speech of 20 December 1925, text in Richmond Times Dispatch, 21 December 1925.

3/ Seligman, "Separation," p. 494.

4/ Ibid., pp. 491-94.

5/ Virginia General Assembly, Tax Commission, Report to the General Assembly, 1911, pp. xii-xiv.

6/ Page, pp. 738-39.

7/ Tax Commission, Report (1911), p. xv-xvii.

8/ Ibid., p. vii.

The Commission also considered the income tax. Although very few of the Commission's recommendations were enacted,[1] this report was significant, since for the first time people in authority gave official consideration to the theoretical advantages and practical difficulties of an income tax. The Commission's conclusions are worth noting since"...many minds were set to working as a result of the effort."[2]

The Commission report recognized that, from a purely theoretical point of view, the income tax is "...one of the best that can be levied...it requires every citizen to give in proportion to his ability to pay; it exactly gauges that ability."[3]

In addition, the report noted that the low revenues yielded by the income tax were due to ineffective administration. In particular, three reasons were given for the failure of the law. First, salaried workers represented a large percentage of the populace, and the income tax was the most onerous tax they bore. Thus there was great pressure on assessors, who were popularly elected, to ignore the tax. Second, deductions (called legal offsets) were liberally interpreted. Finally and more fundamentally, there was no system for checking reported incomes. In Virginia, "...the Commissioner must trust to the taxpayer's statement and even where he has reason to believe that the return is too low, he has no legal means of raising the figures to their proper standard."[4] Such a self-assessed income tax was manifestly impracticable as illustrated by the following description of the operation of the Virginia income tax:

> The individual taxpayer assesses his own income. He may deliberately give a false return; he may conscientiously believe he is entitled to some reductions on exemptions not specifically mentioned in the statutes, but included under the head of "losses," which may mean anything from what he spends on a piano or a home, as to what he lost at cards or in a real estate speculation; he may not return any income above the exemption stipulated in the statute, because Mr. Brown, his neighbor who he knows or believes has a greater income than himself returns no taxable income; he may not be asked to give any income in for taxation by the commissioners; or the commissioner may not have any idea of what "losses" ought to include, or it may not be the custom in his community to obey the law in this particular at all. The plain fact is that it is not thoroughly enforced except in rare instances.[5]

1/ Virginia State Chamber of Commerce (VSCC), Tax Conditions in Virginia, Finance Document No. 1 (Richmond: VSCC, 1925), p. 4.

2/ Stauffer, p. 79.

3/ Tax Commission, Report (1911), p. 356.

4/ Ibid., p. 359.

5/ Sydenstricker, pp. 52-53.

The Commission report concluded that the problems of tax administration and improper deductions could be remedied by the appointment of a permanent, unpaid Tax Commission empowered to formulate rules governing deductions. Thus, reform of the income tax dovetailed neatly into the Commission's plan for modernization and centralization of the tax system as a whole.

The problem of assessing incomes was not so easily solved. The Commission looked favorably upon the English system of "stoppage at source" (roughly equivalent to our withholding), but abandoned it because "...the spirit of our people opposes inquisitorial methods of taxation." Short of such draconic measures, the Commission recommended that employers be required merely to report all wages and salaries paid to employees. These statements would then be prima facie evidence of assessment.[1/]

The Tax Commission's proposals generated considerable controversy. This controversy centered on the property tax.[2/] The fate of the income tax depended on the outcome of this debate, for the income tax was to appear as the means of recouping the revenue loss to the state from separation. The battle over property tax reform had two sides. On one side were those who supported segregation of taxes and local, rather than central, assessment of tangible property. These included the small farmers of the Southwest and Valley whose taxable holdings were of the tangible variety (land, horses, cattle, farm machinery), and who therefore were subject to substantial double taxation. They saw separation's goal of eliminating the state's taxation of tangible property as a way to reduce their tax burden and saw nothing in a centralized tax board but more efficient assessment of tangibles leading to a more onerous tax load.

On the other side of the property tax debate were those who were opposed to separation and who favored a centralized tax board. These included the urbanites and small farmers of the east who owned little in the way of tangible property. They opposed any increase in the taxation of intangible property (which they saw as subverting industry and investment) and leaned naturally toward the idea of vesting assessment power in a central tax commission to run down "tax-escaping farmers."[3/]

At this point battle lines over tax reform were drawn, east versus west and centralization versus separation. The day of the income tax would come only when this battle had expended itself and the inequitities of the system were so glaring as to elicit overwhelming popular support for reform. As one observer noted:

> Virginia at present, gets just enough from her income tax to be unwilling to do away with it, and not enough to render it an important enough source of revenue to become an object of serious reform.[4/]

1/ Tax Commission, Report (1911), pp. 358-61.

2/ The insignificance of the income tax relative to the property tax controversy is manifest in the fact that the Tax Commission discussed the income tax almost as an afterthought in an appendix entitled "Unclassified Recommendations." Tax Commission, Report (1911), pp. 358-61.

3/ John H. Russell, "Sectionalism a Hindrance to Tax Reform in Virginia," in State and Local Taxation (New York: National Tax Association, 1926), pp. 83-84.

4/ Sydenstricker, pp. 52-53.

In fact the income tax was but an inconsequential part of the debate over the Commission's proposals, which passed the House by a narrow margin, but were defeated in the Senate.[1]

The Tax Commission of 1914 and Partial Separation.--The Tax Commission Report of 1911 generated more questions than it answered, so in 1914 a Joint Committee on Tax Revision was created. The committee split along sectional lines. A minority report recommended a policy of "partial" separation, while a majority report advocated the institution of a Tax Commission. When the General Assembly met in special session in 1915 to consider these reports, the minority scored a decisive legislative victory.[2]

A policy of "partial" separation was adopted. This meant that although tax sources were separated, with intangible property generally reserved for state taxation and tangible property primarily reserved for local taxation, the state was allowed to tax tangible property at a low rate (10¢ per $100 valuation) in order to finance public schools.[3] A state "Advisory Board on Taxation" was also created.[4] The tax board, while limited in its power, nonetheless conducted an invaluable comparison of state and federal income tax returns, which "resulted in the discovery of millions of dollars of additional taxable income."[5]

For a time, partial separation worked well. The prosperity of the war years brought high revenues. In 1917 the Auditor of Public Accounts announced that financial conditions were so salubrious that taxes could actually be reduced.[6] But this happy state of affairs could not long endure. New revenues were needed to finance schools and roads, and the state yielded to the temptation of increasing the tax on tangible property up to 25¢ per $100 by 1919. This was only 10¢ off the old, unsegregated state tax.[7] Partial separation was a patent

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1/ Douglas S. Freeman, "The Defeat of the Virginia Tax Reform Bill, 1912," in State and Local Taxation (Madison, Wis.: National Tax Association, 1913), pp. 420-21.

2/ Russell, pp. 81-87.

3/ Stauffer, p. 79.

4/ National Industrial Conference Board, p. 23.

5/ Virginia State Chamber of Commerce, Tax Needs in Virginia, Finance Document No. 4 (Richmond: VSCC, 1925). See Also VSCC, Tax Conditions, p. 19.

6/ Alzado Comstock, Studies in History, Economics and Public Law, vol. 101: State Taxation of Personal Income (New York: Longmans, Green and Co., 1922), p. 96. This was a rather curious thing to say, considering that when the General Assembly met in 1916, it had to wrestle with a $1 million deficit. See Robert Tucker, "Tax Reform in Virginia," Bulletin of the National Tax Association 10 (January 1925), p. 111.

7/ Stauffer, p. 79.

failure as there was no improvement in either the assessment of tangible property or an increase in the amount of intangibles listed[1] (expected because of the lower rates). Owners of tangible property continued to be subject to substantial double taxation.[2] Meanwhile state expenditures continued to increase.[3]

Simultaneously, receipts from the income tax reached new highs as a result of wartime prosperity[4] and legislators turned to it as an unexpected, alternative revenue source.[5] In a change which foreshadowed the developments of 1926, the income tax was made progressive in 1919, according to the following schedule:[6]

Taxable Income	Tax Rate
0 to $3,000	1%
$3,001 and over	2%

By the early 1920's the tax system as a whole was reputed to be more inequitable and less efficient than it had been in 1913.[7] The inequities were rendered all the more painful by the recession of 1921, which also resulted in a considerable reduction in revenues from the income tax.[8] It was under these strained circumstances that the legislature turned its attention again to tax reform.

Business Progressivism and the Tax Commission of 1923.--Southern Progressivism underwent a transformation after World War I. This reform movement, labeled Business Progressivism, stressed governmental efficiency and centralization and called for the application to "...the management of state government the advanced techniques of administrative organization and production efficiency developed by the great corporations."[9]

1/ Tucker, p. 111.

2/ Stauffer, p. 79.

3/ Tucker, p. 111.

4/ Stauffer, p. 101.

5/ Comstock, p. 94.

6/ Virginia, Acts of Assembly (1919), Chapter 43.

7/ Tucker, pp. 111-12.

8/ Stauffer, p. 101.

9/ Pulley, pp. 267-68. Traditionally, historians saw the progressive movement as dying out with WWI; Pulley here builds upon the view, developed in the late 1950's and early 1960's, that Progressivism under went a transformation after the war and continued to influence southern politics through the 1920's. The seminal sources of this interpretation of Progressivism are: Arthur S. Link, "What Happened to the Progressivism Movement in the 1920's?" American Historical Review 60 (July 1959), pp. 833-51 and George B. Tindall, "Business Progressivism: Southern Politics in the Twenties," South Atlantic Quarterly 62 (Winter 1963), pp. 92-106.

Intimations of Business Progressivism can be discerned in Virginia as early as the term of Governor Westmoreland Davis (1918-1922), who believed that "...the affairs of state should be conducted as those of a business concern..."[1/] It was under Davis' successor, E. Lee Trinkle, that in 1922 a Committee on Simplification and Economy of State and Local Government was appointed. In reviewing the tax system, this committee pointed out the same problems as had its predecessors.[2/] With regard to the separation of taxes, committee members believed that "...complete segregation usually brings with it evils and dangers no less serious than those it is intended to remove."[3/] Influenced by the centralization theories of business progressivism, they also recommended a permanent full-time tax board. These proposals elicited a violent reaction from the separationists and the controversy which had embroiled the legislature a decade before was resuscitated. After long and heated debate, a compromise bill was finally agreed upon which effectively diluted the committee's reforms. As a cosmetic reform, the name of the Tax Board was changed to Tax Commission and its composition slightly altered; its powers, however, were not augmented.

As Governor Trinkle's term came to an end, the tax system remained as confused and as inequitable as ever. Particular difficulty existed in the administration of the tax laws and the assessment of property. The deficiencies of the system were succinctly stated in a May 1925 report by the Virginia Chamber of Commerce:

> 1. Virginia has no tax system in the full and correct meaning of the term, but rather a collection of unrelated, overlapping and often conflicting tax laws, many of them apparently conceived in haste and without due consideration of the needs of the State as a whole.
>
> 2. There is, under the present system, no means of obtaining exact information as to the operation of the tax laws or of comparing and balancing the weight of the tax burden upon the different sources of taxpaying ability and incorporating into the laws the equitable principles thus established.[4/]

The problems of the tax system were to provide the impetus for reform, including a major expansion of the state income tax.

1/ Pulley, p. 269.

2/ By 1922, however, the inequities of the system were even greater than in 1912 or 1914. Tucker, p. 111. Tucker provides an excellent summary of the confused state of the tax system just before the Byrd reforms.

3/ Stauffer, p. 79.

4/ VSCC, Tax Conditions, p. 3.

Characteristics of the Pre-Modern Income Tax

Before moving on to its modern history, let us pause to characterize the income tax in the first eighty odd years of its existence.

Reasons for Institution.--An income tax can be justified as a source of revenue or as a method of redistributing income. The Virginia tax was instituted for both reasons. The expansion of the 1840s called for new sources of revenue, while the eastern aristocracy sought to shift the financial burden to the commercial classes. In Virginia's case, the financial need came first and then the question of the allocation of the burden. Were it not for the financial demands of the Civil War, the income tax would probably have been abandoned.[1/]

Low Rates and Low Revenues.--A glance at Table 2.1 gives an idea of the small yield of the income tax throughout the 19th century.[2/] This poor showing was largely due to the low rate which was fixed at 1 percent from 1872 to 1919. Curiously enough, Virginia had the largest revenue from the income tax of the five states who still had income taxes in 1911.[3/]

Constitutionality.--There has never been any question of the right of individual states to impose income taxes under the Constitution of the United States. "Taxing powers of the states is vested in their sovereign rights as constituent members of the federation and retained by them under the residual power doctrine."[4/] Controversy over the income tax has sometimes arisen at the state constitutional level, however.[5/] Virginia has been spared these complications, since an income tax has been embedded in every state constitution since 1851.[6/]

1/ Comstock, p. 28.

2/ Seligman, The Income Tax, p. 415. Except for the abnormally higher revenues during the Civil War, income tax receipts hovered between $30,000 and $50,000 dollars during most of the 19th century. Since total state revenues per year were about $2 million, it follows that the income tax represented anywhere from 1.5 to 2.5 percent of total state annual revenues.

3/ Heller and Penniman, p. 4. In addition to Virginia, the states still using an income tax in 1911 were North Carolina, Massachusetts, South Carolina, and Oklahoma.

4/ Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice (New York: McGraw-Hill Book Co., 1980), p. 33.

5/ For an example of the controversy in Wisconsin, the pioneer in modern income taxation, see National Industrial Conference Board, p. 27.

6/ For a brief discussion of the constitutionality of state income taxes, see Kinsman, Income Tax, pp. 113-14.

This is not to deny that there have been changes in constitutional provisions for an income tax. As we have seen, the 1851 Constitution prohibited taxation of property that was the source of income and this provision was revoked by the Constitution of 1870.[1]

Exemptions.--There was an early appreciation by Virginia lawmakers of the exemption as a policy tool; examples of its manipulation abound. In the 1840s only ministers of the gospel, the governor, and certain judges were completely exempt from the income tax. In 1852, as we have seen, the legislature extended a blanket exemption to all laborors engaged in mechanic art, trade, handicraft, or manufacture. A glance at Table 2.2 shows that the personal exemption was also adjusted up and down throughout the second half of the 19th century. The tax of 1874 limited the exemption to one per family, but allowed guardians to claim an extra exemption for each ward under their protection.[2] There was no special exemption for married couples.

Deductions.--An important innovation in the income tax during the Civil War years was the deduction of business expenses and losses. Although the actual specification of what constituted a deduction changed from time to time, this was nonetheless an important early application of the concept of a net income tax.[3]

Administration.--We have already attributed the low revenues of the income tax to its low rates; this, however, neglects the simple but powerful fact that the tax was too poorly administered to be effective. At its inception in 1843, absolutely no provision was made for administration.[4] There were some improvements over the decades. In 1863 the auditor was empowered to ask a taxpayer for a sworn statement of the veracity of his declaration. In 1866, a penalty of confiscation of omitted items was imposed. In 1870, the tax commissioner was given the power to alter a tax return if he thought it incorrect, but the taxpayer was allowed to appeal the decision to a peer tribunal.[5] All these efforts were ineffective. According to Kennan, the "legislation on the subject betrays the same naive assumption...that it is only necessary to fix by legislative enactment the exact rates to be levied and the administration of the law will take care of itself."[6] As late as 1910, 25 to 30 percent of the counties still did not assess the income tax at all. In fact, it was so easy to avoid the income tax that it was popularly described "as a tax upon the honesty of the citizen."[7]

1/ National Industrial Conference Board, pp. 20-21.

2/ Kinsman, Income Tax, p. 55.

3/ National Industrial Conference Board, p. 21.

4/ Kinsman, Income Tax, p. 39.

5/ Ibid., pp. 45, 47, 48, 52.

6/ Kennan, p. 232.

7/ Sydenstricker, p. 52.

Modern History: 1925-Present

During this period, the importance of the Virginia income tax increased dramatically.

The Byrd Reforms (1925-1930)

There was a general consensus on the need for reform of the tax system and the question of how to do it surfaced as one of the focal points of the 1925 gubernatorial campaign between G. Walter Mapp and Harry Byrd.[1] The alternatives were clearly delineated. Mapp advocated a centralized tax board, while Byrd, true to his rural basis of power, propounded separation.[2] The Democratic machine supported Byrd energetically from the beginning,[3] and Mapp never really had a chance.[4]

In November 1925, just after the election, a series of conferences were held in Richmond on the subject of taxation. In attendance were groups representing "...agriculture, banks and financial institutions, insurance companies, industries, labor, and, indeed nearly every class subject to taxation in the state."[5] From all sides came proposals that "...a more prominent place in the state system of taxation be given to the levy based on income."[6]

On December 21 Byrd unveiled his tax proposals in a pre-inaugural speech in Richmond that marked the inception of the modern income tax. It is therefore useful to review Byrd's rationale for an increased income tax.

Byrd noted his adherence to the philosophy of business progressivism: "... the government should be conducted upon business standards of economy and efficiency and taxes kept within the ability of the people to pay."[7] He then explained his reasons for reforming the existing tax system. One, it created inequities and encouraged tax evasion. Two, he felt the existing system imposed an "unjust" tax upon industrial capital, creating a disincentive to investment and discouraging the importation of capital.

Byrd's remedy to these evils was separation. He proposed "...giving to the localities for exclusive local taxation all real and intangible personal property and to the State all intangible property for preclusive State taxation."[8]

1/ Leo Stanley Willis, "E. Lee Trinkle and the Virginia Democracy, 1876-1939" (Ph.D. dissertation, University of Virginia, 1968), p. 143.

2/ Moger, p. 341.

3/ Dabney, p.481.

4/ Moger, p. 339.

5/ Warren A. McNeil, "An Income Tax for Virginia" (M.A. thesis, University of Richmond, 1926).

6/ Ibid.

7/ Byrd, speech of 21 December 1925, Richmond Times Dispatch.

8/ Ibid.

He also indicated his opposition to centralization and especially to a strong central tax board. He therefore recommended a permanent tax commission, but with only advisory powers. To make up the revenue loss to the state resulting from separation, Byrd proposed an increase in the income tax along with other changes. He favored raising the income tax because "the burden will be more equitable as it will fall upon the taxpayers most able to pay.[1]

The pace of reform accelerated. On February 1, 1926 Byrd delivered his inaugural address, enunciating his plans for a complete overhaul of the government--a sweeping reorganization of which tax reform was only a part.[2] On February 2 he appeared before the General Assembly with a special message on tax reform.[3] On February 4 he delivered an address to the same body on "Simplification of Government in Virginia."[4] "The Byrd era," as one historian puts it succinctly, "was on its way."[5]

Byrd's reforms were widely praised, and Byrd himself was regarded in certain quarters as something of a "wonder boy."[6] Perceptive observers, however, have emphasized that his activity was not disinterested. Many of his comprehensive reforms facilitated the consolidation of the "machine."[7] In addition, separation was aimed explicitly at alleviating the tax burden of the farmers, from whom Byrd received most of his support.[8] Throughout his career Byrd was to be carefully solicitous of Virginia's farmers. In this respect the income tax was

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1/ Byrd, speech of 21 December 1925, Richmond Times Dispatch.

2/ "Progressive and Sane Reforms, Byrd's Pledge in Inaugural Address," Virginian-Pilot, 2 February 1926.

3/ "Byrd Tax Plans are Laid Before General Assembly," Virginian Pilot, 3 February 1926.

4/ "Byrd Outlines in Detail Plans for Consolidation of Governmental Agencies," Virginian-Pilot, 4 February 1926.

5/ Moger, p. 342.

6/ Ibid., p. 344. For an example of the idolatry which Byrd often enjoyed see French Strother, "Youth Takes the Helm in Virginia," World's Work LIII (1926-1927), pp. 140-42.

7/ J. Harvey Wilkinson, III, Harry Byrd and the Changing Face of Virginia Politics, 1945-1966 (Charlottesville: University Press of Virginia, 1970), pp. 7, 31-32. See also Dabney, p. 482; V. O. Key, Jr., Southern Politics in State and Nation (New York: Alfred A. Knopf, 1949), pp. 15-35; and William Manchester, "The Byrd Machine," Harper's Magazine, November 1952, p. 81.

8/ Message on Taxation to General Assembly, 2 February 1926. This was also emphasized in the 21 December speech.

a particularly attractive source of new revenue, since its burden would fall more heavily on the cities than on the farms. Professor Stauffer explains:

> Quite naturally the bulk of the returns are filed from the urban areas. Several factors account for this. First, it is well-nigh impossible to achieve any satisfactory results from the income tax in the case of farmers. Only a few of them keep records which permit any accounting of income. Moreover, even for those who have records it is difficult to estimate a true net income to serve as the basis of an income tax. To look at one phase of this problem, take the question of the farmer's living, a good deal of which he produces himself. How accurately can the worth of food produced for personal consumption by the farmer be computed, assuming that this constitutes a form of real positive income? In the case of the wage earner most of the food he uses is paid for out of the wages or salary which he receives, no deduction from his taxable income being permitted on account of personal expenditures of this sort. To the farmer the value of food consumed is no less representative of income than the wage or salary of the urban resident spent for this purpose.1/

Separation and administrative reform were integral parts of Byrd's consolidation of power. The income tax was a vital element in the implementation of separation and, hence, in Byrd's political strategy.

Blessed with statewide popularity, and powerful in his overlordship of the machine, Byrd had no difficulty in instituting his reforms. The legislature of 1926 passed "a whole series of far-reaching bills...with hardly any opposition, some of them unanimously,"2/ including a graduated income tax, with the rate structure:

Taxable Income	Tax Rate
0 to $2,999	1.5%
$3,000 to $4,999	2.5%
$5,000 and over	3.0%

Exemptions were set at $1,000 for a single individual, $2,000 for a married couple, and $400 per dependent. Other tax reforms were achieved in the remaining three years of Byrd's term, including establishment of a Department of

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1/ Stauffer, p. 111.

2/ Dabney, p. 482.

Taxation headed by a full time Tax Commissioner.[1] Thus, in a veritable explosion of activity, the legislature brought the Virginia tax structure into the 20th century.

The tax reforms seemed immediately successful. In 1927, Byrd argued that the new tax system had been successful in attracting industry by pointing out that in "fiscal year 1927 Virginia made the largest industrial progress of any state in the nation."[2] In 1929, as Byrd's term drew to a close, the tax commissioner sent a proud enumeration of the successes of separation to the governor noting, "The segregation plan of taxation, in actual operation, has been far more successful than the greatest expectation of its most ardent advocates."[3] He also reported that the accomplishments of the Department of Taxation included the "vitalization of the administration of the individual income tax law."[4]

There were critics, to be sure. Professor Stauffer of the University of Virginia felt that rates on higher income classes should be increased.[5] The New York Bureau of Municipal Research found fault with the organization of the tax department because there was some overlapping of functions with other departments.[6] However, the fact that the Byrd reforms marked a watershed in Virginia history was as clear to contemporary observers as to modern historians.[7]

The election of Byrd machine candidate John Pollard as Governor in October 1929 was taken as a popular mandate for the continuation of the Byrd reforms.[8] That this election took place at the same time as the greatest financial collapse in American history in no way disturbed the reigning spirit of optimism in Virginia.[9] All omens augured well. In January, as he left office, Byrd could still state unequivocally that:

1/ Virginia Department of Taxation, Annual Report 1929, p. iii.

2/ Dabney, p. 483.

3/ Virginia Department of Taxation, Annual Report 1929, p. iv.

4/ Ibid.

5/ Stauffer, pp. 124-25.

6/ Virginia State Chamber of Commerce, Reorganization of Executive Agencies in Virginia (Richmond: VSCC, 1940), pp. 8-9.

7/ For modern assessments see Wilkinson's introduction, pp. 1-8; Moger, p. 344; and Dabney, pp. 420-84.

8/ Dabney, p. 488.

9/ Ronald L. Heinemann, "The Great Depression in Virginia, 1929-1934" (M.A. Thesis, University of Virginia, 1967), p. 6.

> The close of the year 1929 sees Virginia facing a bright future. Never, probably, in the long history of the Old Dominion has she faced a destiny more filled with promise.[1]

Depression and Recovery (1930-1940)

The darkening clouds of national Depression had as yet cast little shadow on Virginia,[2] and the General Assembly felt confident enough to reduce the income tax burden by raising the exemptions.[3] In 1931 the situation began to deteriorate, however. Unemployment rose, retail sales fell, and Pollard had to announce an impending deficit for the 1930-32 biennium.[4] Pollard's reaction to the situation was one of retrenchment.[5] He cut his own salary by 10 percent, reduced road appropriations, refused an increase in educational expenditures and cut general fund appropriations.[6] By July 1933 opposition to the policy of retrenchment began to emerge.[7] The machine now shifted gears. In a special session the new General Assembly implemented the establishment of a federal public works program.[8]

But by now Virginia was already emerging from the Depression. The Virginia economy showed a definite upturn in 1933,[9] and the National Recovery Administration (NRA) had begun to work its psychological magic.[10] The new spirit

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1/ Harry Byrd, Norfolk Virginian-Pilot, 1 January 1930 quoted in Heinemann, p. 9.

2/ Heinemann, p. 10.

3/ Virginia, Acts of Assembly (1930), chapter 46. Specifically, the exemptions were raised from $1,000 to $1,250 for unmarried individuals and from $2,000 to $2,800 for married couples. The dependent exemption remained at $400. The earlier exemptions had been set in 1922, with an adjustment in 1928 which allowed a taxpayer with a dependent to claim a $2,000 exemption plus the $400 for the dependent. See Virginia, Acts of Assembly (1922), Chapter 463 and Acts of Assembly (1928), chapter 309.

4/ Heinemann, pp. 17-18.

5/ The fiscal conservatism of Byrd and the Organization can be traced directly to Virginia's financial difficulties after the Civil War. See Wilkinson, p. 4.

6/ Heinemann, pp. 24, 28, 32.

7/ Ibid., pp. 39-40.

8/ Virginia State Chamber of Commerce, "Next Steps" in Taxation and Government in Virginia: Reports of the Committee on Taxation and Government of the Virginia State Chamber of Commerce (Richmond: VSCC, 1936), p. 2.

9/ Heinemann, pp. 42-49.

10/ Heinemann, p. 41. "By September, public rejection of any phase of the New Deal program was unthinkable. It had seemingly performed miracles on the economy and on the mood of the people; events in Virginia confirmed this euphoria."

of optimism helped the new Byrd machine candidate, Campbell Peery, carry the race for governor. In his inaugural address in January 1934, Peery reiterated the machine's position, "We need economy in government today, as we have never needed it before."[1/] Nonetheless, his new budget did include a $1 million increase in expenditures on education, which had been particularly hard hit. This was financed by a decrease in the income tax exemption.[2/]

The upturn that had begun the year before continued in 1934.[3/] Although there was still a deficit of $2,291,000, the worst was over. By June 1935 the deficit was down to $1,727,000, and by the next year it was liquidated. Virginia and the Byrd machine had weathered the storm.[4/]

What was the legacy of the Depression for Virginia? It did not lie in any long-run economic effects, for the Depression in Virginia came fairly late, left early, and was comparatively mild.[5/] The importance of the Depression to Virginia was more political than economic. It vindicated the orthodox fiscal policies of the Byrd machine, both to the public and to the politicians themselves. But this is better said by Harry Byrd himself:

> Let other states go the way they prefer, but we in Virginia can continue the less-spectacular paths of industry and thrift; paying as we go and then pay just as little in taxes as necessary for our essential functions of government...[6/]

Despite the rhetoric of politicians, however, careful observers saw that the Depression had underscored the great weakness of separation. Having abandoned the stable tax bases of real estate and personal property, the state had come to rely increasingly on business and personal income taxes. Thus, state revenues had become uncomfortably dependent upon the vagaries of the business cycle. In the face of this volatility, the state had only two alternatives according to the Virginia State Chamber of Commerce:

1. To adopt a policy of accumulating surplus revenues during periods of prosperity, and using them as a buffer during times of recession, or

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1/ Heinemann, p. 53.

2/ The new exemptions were: unmarried--$1,000; married--$2,000; and dependent--$200.

3/ Heinemann, pp. 61-64.

4/ VSCC, "Next Steps," p. 2.

5/ Ibid., p. 64.

6/ Speech at the University of Virginia, 30 October 1935, quoted by Heinemann, pp. 71-72.

2. To find an alternative source of revenue-such as a sales tax-that would not fluctuate.1/

"Unless one or both of these is adopted," said the Chamber, "the functions of the state government are endangered by such wide fluctuations in the revenues of the general fund as have occurred during the past six years."2/ But this was not the worst of it. If the state had any intention of expanding its services,3/ a sales tax "would necessarily have to be imposed in order to finance the cost of the programs."4/ The machine stood as adamantly against a sales tax as it did for a balanced budget, however. The burden of the business and personal income taxes was born primarily by the cities and urban counties, where incomes were high. A sales tax, on the other hand, would inevitably shift part of the burden to the farms. "The Byrd organization did not welcome any tax which spread a greater part of the cost of government to its rural strongholds."5/ A sales tax was not to be. The inevitable result was what many observers considered to be an inadequate funding of such vital public functions as education.6/ An equally inevitable, though less widely recognized outcome was the increasing reliance on the income tax as a source of revenue.

World War II and Post-War Developments (1941-1948)

World War II spelled prosperity for Virginia. The income tax brought revenues unparalled in its history and the state enjoyed a comfortable surplus.7/ These salubrious conditions could not disguise the intrinsic precariousness of the tax system, however. As the Virginia State Chamber of Commerce (VSCC) pointed out in 1945, the surplus resulted from a decline in state services during the war and from the artifical stimulus of war expenditures. With peace would come both increased demand for state services and slower growth. Thus concluded the VSCC:

1/ VSCC, "Next Steps," p. 5.

2/ Ibid.

3/ This was advocated by James Price who, elected governor in 1937, was an advocate of the New Deal and emphatically not part of the Byrd machine. See Moger pp. 355-66 and Wilkinson, p. 8.

4/ VSCC, "Next Steps," p. 10.

5/ Wilkinson, p. 41. Several other states, "desperate for revenue," did impose sales taxes. See George Brown Tindall, A History of the South, vol. X: The Emergence of the New South, 1913-1945 (Louisiana State University Press and the Littlefield Fund for Southern History, 1967), p. 369 and Robert Murray Haig and Carl Shoup, The Sales Tax in the American States (New York: Columbia University Press, 1934).

6/ See Wilkinson, p. 41; Moger, pp. 366-367; Dabney, p. 560; and Key, p. 27.

7/ Virginia State Chamber of Commerce, Opportunities for the Improvement of the Virginia State Tax Structure (Richmond: VSCC, 1945), p. 158.

> ...Virginia's tax system is not adequate to provide the type of educational, public health, and other services which have become generally recognized throughout the state as necessary in the post-war period...1/

In short, taxes had to be increased. If a sales tax was unacceptable, then rates on existing taxes would have to rise. The obvious choices were the individual and corporate income taxes. The VSCC recommended the former, calling for an increase in the rates on upper tax brackets.2/ The VSCC plan did not treat the question of cyclically unstable receipts, but it did promise to raise revenues. It would also make the income tax more progressive, which the VSCC felt was desirable on grounds of equity.3/

The immediate issue at the end of the war was, therefore, whether income taxes should be raised. The question was brought to a head by Governor Tuck's proposal in 1948 to increase taxes according to the schedule:

Taxable Income	Tax Rate
0 to $2,999	2%
$3,000 to $4,999	3%
$5,000 and over	5%

Despite the support of the VSCC, some parts of the business community reacted violently to the proposal. The Richmond Chamber of Commerce, for example, felt that:

> ...the time has come to call a halt to further expansion in government spending and taxation. We stand on the brink of an economic precipice. Now is the time to secure, not further jeopardize our position. At such a time, and under such conditions, it is fantastic to think that Virginia would add heavily to its tax burden, ranking it among the higher tax states in the nation, mortgaging its emergency reserves for the future.4/

The argument in favor of raising the income tax had been put forth by the Virginia State Chamber of Commerce in 1945: Virginia's growth had little to do with its "low tax" reputation, and much to do with "sound fiscal administration

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1/ VSCC, Opportunities, p. 159.

2/ Ibid., p. 43.

3/ Ibid., pp. 49, 167.

4/ Richmond Chamber of Commerce, Virginia at the Crossroads (Richmond: RCC, 1948).

and the relative stability of the tax structure."[1] The critical fact, however, was that Virginia desperately needed the revenue. Although there was opposition, Governor Tuck eventually forced the bill through the legislature.[2]

In retrospect, the 1940s were a critical period in the growth of the income tax. Receipts grew from $1.8 million in 1940 to $23.7 million in 1950--a thirteen fold increase. Over the same period, the percentage of total tax revenues provided by the income tax nearly quadrupled--rising from 5.2 percent to 19.5 percent.[3] Much of this increase was attributable to a phenomenal increase in the number of returns filed. In fiscal year 1940 only 49,955 returns were filed, while 533,311 returns were filed in 1950. The Tuck Bill also led to a large increase in revenues, some 68.3 percent between 1949 and 1950 alone.[4]

Abortive Challenges to Organization Tax Policy (1949-1954)

By the late 1940s, post-war inflation was cutting deeply into local budgets, and it was becoming increasingly evident that the state would have to aid localities in providing many essential services.[5] The question, as always, was from where the requisite revenues should come. To the extent that the Byrd organization admitted any need for an increase in taxes, it advocated the extension of the individual and corporate income taxes. This policy was embodied in the Tuck bill of 1948. Opposition to the organization's stance emanated from those sectors which bore the burden of the tax increases--the business community and the growing urban areas. An articulate champion for these disenchanted groups appeared in Horace Edwards, a disgruntled organization man who decided to run for governor without Byrd's proverbial "nod." Edwards argued

> ...that the present taxes, including the Federal tax and the increased State taxes which go into effect this year, are approaching the confiscatory stage so far as small business and industry are concerned....A sales tax with its broad base seems to me to be the most equitable new tax.[6]

Edwards was defeated, but his campaign underlined the strength of the opposition to the higher income taxes and succeeded in making the sales tax a political issue.

1/ VSCC, Opportunities, p. 172.

2/ Wilkinson, p. 41; Dabney, p. 519. The tax bill did not change the exemptions.

3/ See Table 2.3.

4/ Sara K. Gilliam, The Trend in Taxes Paid by Virginians, 1940-1950, (Charlottesville: Bureau of Population and Economic Research, University of Virginia, 1952), pp. 19-20.

5/ Wilkinson, pp. 90-91.

6/ Richmond-Times Dispatch, 15 June 1949, quoted by Wilkinson, p. 95.

With great difficulty the organization reasserted its political hegemony. For the first time, however, there were signs of dissension within the machine. While moderate members of the machine recognized the need for new revenue sources, more conservative members opposed tax increases of any kind. The new governor, John Battle, sought to follow the moderate course set by Tuck. His first achievement in the 1950 General Assembly was the initiation of a program which channeled the "embarrassment of riches" from the expansion of the income taxes into public education.1/ The more conservative wing of the organization, however, was concerned that the Tuck bill had made Virginia a "high tax state."2/ State Senator Harry Byrd, Jr. thus sponsored a bill in the General Assembly which required a surplus to be offset by tax credits to individuals and business. In particular, the Byrd bill stated that, "...if general fund revenues for a fiscal year exceeded budget estimates by X percent, then individual and corporation income taxpayers would receive a reduction of X percent in their income tax bills."3/ This bill was passed by a large majority and, in the next five years, returned some $25 million to taxpayers.4/

The Byrd Tax Credit Act placed a painful constraint upon the provision of many state services, particularly public education.5/ According to one analyst:

> The Byrd Organization was allowing its obsession with a balanced budget to overshadow its commitment to public education and other vital state services. The early 1950's would have been the ideal time for the Byrd organization to shift gradually from an economy-minded to a public-school-minded attitude. It did not do so, and consequently it invited trouble in the years ahead.6/

These troubles began almost immediately. In 1953 a group of young noviates of the organization--appropriately called the "Young Turks"--rebelled against the dogma of fiscal conservatism. They concentrated their attack on the Byrd Tax Credit Act, which would have required $7 million in the General Fund to be returned to the taxpayers in 1953. The battle lines were clearly delineated. The Young Turks wanted the money spent on schools, while the organization supporters wanted the act to stand. After a long, heated legislative battle a

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1/ Wilkinson, p. 98.

2/ Dabney, p. 523.

3/ Wilkinson, p. 99; Virginia, Acts of General Assembly, (1950), p. 16.

4/ Dabney, p. 523.

5/ For some statistics highlighting the inadequacy of Virginia's schools relative to those of other states in 1950, see Dabney, p. 530.

6/ Wilkinson, p. 101.

compromise was reached whereby approximately $2 million was kept in the General Fund, and the remainder returned.[1] Although the Young Turks were to be thoroughly chastized by the organization, their "rebellion" signaled the imminent demise of the Byrd Tax Credit Act.[2]

Fiscal Ingenuity (1955-1958)

In the face of a growing need for state expenditures, Governor Thomas Stanley in 1954 appointed a commission to investigate the capital requirements of the state and to suggest means of financing them. The Commission finished its report in August 1955, recommending approximately $110 million in capital expenditures over the next six years. A small fraction of this total should be financed by floating a bond issue; the rest, the Commission argued, could be gleaned from an ingenious restructuring of the payment schedules of state taxes on public service corporations and individual incomes.[3]

Virginia's income tax was due by December 5 of the year following the close of the income tax year (the calendar year) so that there was an eleven month hiatus between the tax period and payment. The Commission's plan was essentially to move up the payment deadline from December 5 to May 1. In the fiscal year of implementation, the state would then enjoy a doubled revenue income, from the taxes due May 1 and from those due the preceding December 5.[4] This revenue windfall was intended to finance the state's capital expenditures for the next six years.[5] In 1956 the General Assembly implemented the Commission's proposals in a bill which simultaneously revoked the Byrd Tax Credit Act. Thus in fiscal year 1957, income tax revenues increased 130.9 percent.[6]

The reasoning behind this plan was succintly and frankly stated by Tax Commissioner C. H. Morrissett:

> The alternative to changing the dates for the payment of the taxes on public service corporations and individual incomes was an increase in taxes, or the imposition of new taxes.
>
> The beneficiaries of the State's capital expenditures are the people of the State. It was demonstrated in 1955 that

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1/ Wilkinson., p. 111.

2/ Ibid, p. 112. "The Young Turks paid dearly for their independence. Those who arrived in the Senate in 1956 were shunted to inferior committees, and their hopes of running as statewide organization candidates quickly dimmed."

3/ C.H. Morrissett, "Virginia's General Fund: Major Developments," University of Virginia News Letter 35, no. 6 (15 December 1958), p. 21.

4/ Ibid., p. 22

5/ Ibid., pp. 21, 23.

6/ See Table 2.3

> capital improvements at the State institutions throughout the state were badly needed. Procuring the money by changing the dates for the payment of the taxes seemed to be far preferable to an increase in taxes, and our people in good spirit made the small sacrifice in 1957 that was requested of them for the public good.[1/]

Quite simply, the rationalization of the payment schedule of the income tax was the direct result of the refusal of the organization to implement a general sales tax or raise other existing taxes.

Withholding (1962)

Oregon implemented the first payroll withholding plan for a state income tax in 1948.[2/] Although there seemed to be significant gains in administrative efficiency from withholding, most states were slow to follow Oregon's example.[3/] In Virginia the Advisory Legislative Council undertook a study of withholding in 1956.[4/] The Council admitted that withholding would reduce tax evasion and delinquencies. It also recognized that withholding would be particularly beneficial to Virginia because a large proportion of the total income tax base was composed of wages and salaries, and many Federal employees, known to be subject to frequent reassignment, lived in Virginia. On the other hand, the Council felt that withholding posed two insurmountable problems. First, industry would have to bear the burden of additional paperwork, and the tax department would have to face the formidable task of making thousands of refunds annually. Second, and more importantly, withholding would require a more centralized administration. Any policy which had overtones of "centralism" was anathema to the organization ever since Byrd's opposition to and defeat of centralization in the 1920s. The Council argued that concentration of tax administration would only depersonalize government, inconvenience the taxpayer, and increase administrative costs. In sum, the Council felt the disadvantages of withholding to outweigh the advantages.[5/] The legislature concurred and took no immediate action to institute withholding.

For five years the withholding question remained dormant. Finally, in 1962, the General Assembly reversed its position and passed a bill implementing withholding. Since the arguments against withholding were the same in 1962 as in 1957, what had happened in the intervening five years to bring about this about-face? "The answer," said Commissioner Morrissett candidly,

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1/ Morrissett, p. 23.

2/ Clara Penniman, State Income Taxation (Baltimore: Johns Hopkins University Press, 1980), p. 47.

3/ Ibid., p. 54. By 1959 less than half the states with income taxes had implemented withholding.

4/ Virginia General Assembly, Virginia Advisory Legislative Council, Withholding of State Income Taxes, House Document No. 11, 1956.

5/ Ibid., pp. 5, 7-8.

> ...is that the additional revenue the plan will yield was found to be necessary to balance the general fund budget of the state for the biennium beginning July 1, 1962 and ending June 30, 1964. There was no other acceptable plan before the General Assembly for the raising of the needed revenue. The plan was regarded as preferable to imposing a new tax or increasing tax rates on existing subjects.[1/]

Three aspects of the State Income Tax Withholding Law of 1962 should be emphasized. First, it served as an expedient which allowed the machine to postpone implementation of a sales tax. This was stated explicitly by Morrisett himself after implementation of the sales tax in 1966:

> This [the sales tax] had been avoided by the adoption of various devices such as acceleration of payment of some principal taxes in Virginia in 1957 and the adoption of State income tax wihholding effective as of January 1, 1963.[2/]

Second, only a small part of the additional revenue expected by Morrisett between 1962-1964 was to be due to the improved collection techniques of withholding. The bulk (roughly 75 percent) of the extra revenues would be a windfall gain from the simultaneous receipt in the second quarter of 1963 of the first quarterly withholding payments for tax year 1963 and the regular tax payments for tax year 1962. This was reminiscent of the windfall revenue of 1957.[3/]

Third, the Committee Report of 1957 had rejected withholding because it threatened centralization of the taxing process. "The Act of 1962 meets this objection," said Morrissett, "by providing that although taxes must be paid by employers directly into the state treasury...the individual income taxpayers will continue to file...with the commissioners of the revenue of the counties and cities."[4/] Withholding in short, had to take a form appropriate to Virginia's tradition of local self-government. The jobs of the local commissioners of revenue, who were an essential part of the machine's courthouse politics, were left secure.

1/ C.H. Morrissett, "Virginia's New State Income Tax Withholding Law," University of Virginia News Letter 39, no. 3(15 November 1962), p. 9.

2/ C.H. Morrissett, "Major Tax Enactments of the 1966 Virginia Assembly--and Interpretative and Procedural Problems Encountered to Date," 12th Annual Tax Conference, Marshall-Wythe School of Law, College of William and Mary (1967), pp. 37-43.

3/ Morrissett, "Virginia's New Withholding Law," p. 9.

4/ Ibid.

The Sales Tax Legislature (1966)

The year 1966 witnessed a "quiet revolution" in Virginia politics;[1] led by Governor Mills E. Godwin, Jr., the legislature finally instituted a state sales tax. The immediate effects of this new revenue source on the income tax were slight, however. Despite some talk of lowering the rates in the bottom brackets in order to compensate for the impact of the sales tax on low income classes,[2] there was no change in the income tax. The General Assembly did create a Commission to study the desirability of conforming Virginia's income tax laws with those of the federal government, however. This ushered in the next phase in the development of the current income tax structure.

Gradual Implementation of Conformity (1967-1972)

The idea of reconciling the state and federal tax systems had a long history in Virginia. Harry Byrd had endorsed the idea in his preinaugural speech of 1925.[3] It had also been advocated by the Virginia State Chamber of Commerce in 1945.[4] State tax policy was already designed to facilitate the eventual integration of the two systems. In 1962, for example, the scheduling of Virginia withholding was explicitly designed to match that of federal withholding.[5] Meanwhile the Tax Department adopted a stance of following the federal system whenever possible,[6] and in 1964 the General Assembly took steps to make state and federal taxation of income from corporate stocks and bonds more uniform.[7]

Although the stage was set for conformity, the technical issues involved were first confronted by the Income Tax Study Commission, which published its report in 1967. Since the Commission's views greatly influenced the subsequent structure of the income tax, we shall follow its arguments at some length.

1/ C. F. Hicks, counsel for the Virginia Association of Counties, quoted by Wilkinson, p. 301.

2/ Waller H. Horsely, "Developments Bearing on the Future of Taxation in Virginia," 11th Annual Tax Conference, Marshall-Wythe School of Law, College of William and Mary (1966), p. 15.

3/ Byrd, speech of 21 December 1925 Richmond Times Dispatch.

4/ Virginia State Chamber of Commerce, Opportunities for the Improvement of the Virginia Tax Structure, Finance Document No. 11, (VSCC: 1945), pp. 43-48.

5/ Virginia General Assembly, Virginia Income Tax Study Commission, Toward A Simplified Income Tax System, House Document No. 17, 1967, p. 20.

6/ H. Brice Graves, "Tax Legislation Enacted by the 1964 General Assembly of Virginia," 10th Annual Tax Conference, Marshall-Wythe School of Law, College of William and Mary (1965), p. 15. See also R. Braxton Hill, Jr., "Advantages and Disadvantages to Virginia Businessmen in the Reconciliation of Certain Major Accounting Areas as Between Federal and State Tax Laws," 14th Annual Tax Conference, Marshall-Wythe School of Law, College of William and Mary (1968), pp. 97-98.

7/ Graves, p. 15.

The Commission listed several arguments in favor of conformity.[1] These included: the increased convenience to taxpayers; the reduced administrative burden to the Tax Department; and the availability of federal computer tapes at minimal cost, which would render the auditing process much more efficient.[2] Despite a dissenting opinion by C. H. Morrissett and George Fischer, the Commission had little doubt as to the general desirability of conformity.[3] The body of the Commission's report thus revolved around the technical questions of: 1) which type of conformity statute to implement, 2) how to adjust the state tax to changes in the federal, and 3) whether a few specific provisions of the state tax should be allowed to vary from conformity. We will look at each of these issues in turn.

The Commission considered two types of conformity: applying a percentage to federal income tax liability (a so-called piggyback tax) or accepting the federal definition of taxable income and then applying its own rates.[4] The problem with the former alternative is that it causes state tax receipts to vary with changes in federal rates. This not only allows revenues to fluctuate beyond the control of the state legislature, but it also forces the state to adopt the progression of the federal rate structure. For these reasons, the Commission felt that rather than adopt a piggyback tax, Virginia should adopt the federal definition of taxable income, while maintaining its existing rate structure.[5]

Since taxes evolve over time, in implementing conformity the question arises whether the state should conform to the federal system at a given moment in time (fixed base) or whether it should automatically adopt whatever changes might occur over time in the federal system (moving base). Conformity to a fixed base has the advantages of protecting the state from unforeseen changes in revenue and keeping some discretionary taxing powers in the state capital. The disadvantage of the fixed base is that if it is kept fixed for too long, the gains

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1/ Virginia General Assembly, Toward a Simplified Income Tax System, pp. 7-9.

2/ Another argument in favor of conformity, not expounded by the Commission, was related to the imminent retirement of Commissioner Morrisset. In the words of one observer: "Many tax practitioners are disenchanted with the informality of income tax administration in the State and concerned about future interpretation once the 40-year continuity of administration is broken, and the federal system is the only available taxing system which offers an extensive body of law and administrative practices which are familiar to and touch all of the State's citizens." Horsely, p. 15.

3/ It is interesting that while the Commission has sub-headings on "Advantages to Taxpayers" and "Advantages in Administration," it nowhere explicitly discusses the disadvantages of conformity. This is a revealing asymmetry in the logic of their argument.

4/ Another alternative, not considered by the Commission, would be to conform to federal adjusted gross income and keep deductions, exemptions, and rates as discretionary instruments, which was the format ultimately adopted. For definitions of federal taxable income and adjusted gross income, see Chapter 4.

5/ Virginia General Assembly, Towards a Simplified Tax System, pp. 24-25.

from conformity will be lost.[1] The Commission reviewed changes in the federal income tax between 1960 and 1967 and found that, despite several major revisions of the federal tax code, there would have been no serious damage to state revenues had conformity already been adopted. The Commission recommended a moving base, concluding that:

> ...the advantages to taxpayers and to the Commonwealth of a steadily conforming law outweigh the risk of possible dislocations that might occur as a result of future federal changes in the definition of taxable income. If a serious change should occur, the General Assembly can eliminate the effect of the federal change by amending the Virginia law to require an offsetting adjustment to federal taxable income.[2]

The Commission did believe that in several specific cases the state should deviate from the federal definition of taxable income. Some of these exceptions were relatively minor, such as not allowing deduction of state income taxes; others, such as exempting interest on federal obligations, were required by the federal Constitution.[3]

The levels of personal exemptions and standard deductions were also considered and the Commission recommended conformity. In 1967 Virginia allowed a $1,000 exemption per taxpayer and spouse, $600 per dependent and $600 for those elderly or blind. Federal law, on the other hand, gave a $600 exemption for each member of the family. This would tend to shift the tax burden away from large families toward small families and unmarried individuals. Some observers held that this distributional effect should be avoided by retaining Virginia's existing structure of exemptions. The Commission argued, however, that the change in exemptions had to be seen in the context of the across-the-board increase in standard deductions that would accompany conformity. The maximum standard deduction in Virginia at the time was $500, while it was $1,000 at the federal level. The rise in the standard deduction would cushion the decline in exemptions for one and two person households.

The Commission also examined the treatment of capital gains. Prior to conformity, Virginia treated capital gains, whether short or long term, as ordinary income, and allowed capital losses to be deducted in full. Federal law at the time allowed deduction of 50 percent of long term capital gains and a maximum of $1,000 for capital losses.[4] The Commission believed that the simplicity of the

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1/ Virginia Department of Taxation, Research Division, "Issues for Individual Income Tax Reform in Virginia," by Nancy D. Suttenfield, Issue Paper, no. 8 (1979), pp. 8-9.

2/ Virginia General Assembly, Towards a Simplified Tax System, p. 26.

3/ For a complete list of recommended deviations from federal law see Virginia General Assembly, Towards a Simplified Tax System, pp. 10-16.

4/ Current federal law allows a deduction of 60 percent of long term capital gains.

Virginia rule made it superior to the federal rule.[1] Nonetheless, the Commission recommended that Virginia adopt the federal rule for two reasons. First, investment decisions would be made with federal rates in mind. Second, the overall gains to conformity far outweighed the concomitant increase in complexity in capital gains taxation.[2]

Finally, as noted, the Commission did not recommend that the state adopt the federal rate structure. The Commission also did not favor adoption of "income splitting" as the federal government then allowed. The federal law at that time allowed a married couple to either file separately or to file a joint return and pay twice the tax which would be imposed if the taxable income were cut in half. Implementation of this provision at the state level would appreciably reduce the tax liability of one-earner married couple households. This, in turn, would entail a loss in revenue that the state could ill afford. The Commission therefore decided against the use of income splitting.

In sum, the Commission was enthusiastically in favor of conformity to federal taxable income, while continuing the use of the existing Virginia rate structure without income splitting. As we have seen, this commitment to conformity even included recommending the adoption of the federal rules on capital gains and the acceptance of the lower federal exemption and higher federal standard deductions.

There was one obstacle in the way of immediate enactment of conformity, however. According to the Virginia Constitution,

> ...every law imposing, continuing or reviving a tax shall specifically state such a tax, and no law shall be construed as so stating such tax which requires a reference to any other law or any other tax.[3]

Although the legal consultant to the Commission felt conformity did not violate this provision, others held it to be a "blatant contravention" of the state Constitution.[4] This constitutional ambiguity thwarted enactment of conformity legislation for three years. Finally, in a general referendum in 1970, Virginia voters approved a constitutional amendment which expressly allowed incorporation of federal tax statutes into Virginia law.[5]

1/ The Virginia rule also had the advantage of creating a broader base for the income tax. See Chapter 4.

2/ Virginia General Assembly, Towards a Simplified Tax System, pp. 17-18.

3/ Virginia, Constitution (1902), Section 50.

4/ Virginia General Assembly, Toward a Simplified Tax System, pp. 25, 28. Quoted from the dissenting opinion of C. H. Morrissett and George Fischer.

5/ Virginia, Constitution, Article IV, Section 11.

By 1970, however, the revenue impact estimates of the Income Tax Study Commission were out of date. The Federal Tax Reform Act of 1969 had increased both the federal standard deduction and exemptions, and had introduced a minimum standard deduction called the low income allowance.1/ Conformity under these new liberal provisions threatened to cause a sizeable loss in revenue to the state. An Income Tax Conformity Statute Study Commission was created to evaluate this problem and prepare new revenue impact estimates. The report of this Commission, published in January 1971, reiterated most of the arguments made by the Commission of 1966.2/ Only in one essential respect did the conclusions of the new commission differ from those of the old--the revenue loss from liberalized federal deductions and exemptions was simply too large to be sustained. The Commission proposed that, while the state should adopt the federal standard deduction and low income allowance, it should use a $600 exemption.

Acting upon the Commission's recommendations, the General Assembly enacted conformity in April 1972.3/ Virginia taxable income was defined to be federal adjusted gross income modified by a list of additions and subtractions adopted from the Commission's draft statute.4/ The standard deduction and low income allowances were set at federal levels. The personal exemption, as recommended by the Commission, was set at $600, even though the current federal exemption was higher and was scheduled to increase still further.

The single Virginia rate schedule was maintained, as Virginia did not follow the federal practice, instituted in 1969, of using different rate schedules dependent on filing status--single, married filing jointly and filing separately, and head of household. The General Assembly did add a new bracket of 5.75 percent on taxable incomes over $12,000 in order to finance a "landmark" increase in the budget.5/ This resulted in the following rate schedule, still in effect today:

1/ "The Tax Reform Act of 1969 increased the minimum standard deduction (low income allowance) to $1,000 for 1972 and $1,300 thereafter; the maximum standard deduction increased from 10 percent of AGI up to $1,000 to 14 percent of AGI up to $2,000 for 1972 and 15 percent of AGI up to $2,000 thereafter. The allowance for personal exemptions increased from $600 in 1971 to $700 for 1972 and $750 thereafter." Virginia Department of Taxation, Research Division, "Virginia's Conformity to the Federal Individual Income Tax Laws: An Evaluation After Three Years," by Robert T. Benton and Elizabeth P. Martin, 1975.

2/ Virginia General Assembly, Virginia Income Tax Conformity Statute Study Commission, Implementation of a Simplified Tax System for Virginia Taxpayers, 1971, pp. 10, 11.

3/ Virginia, Acts of Assembly, (1972), Chapter 827.

4/ Virginia, Code, Title 58; Virginia General Assembly, Implementation, Appendix, pp. 4-7.

5/ John Warren Cooke, "The Speaker Looks at the 1972 General Assembly," University of Virginia News Letter 49, no. 1 (15 September 1972), p. 2.

Taxable Income	Rate
0 to $2,999	2%
$ 3,000 to $4,999	3%
$ 5,000 to $11,999	5%
$12,000 and over	5.75%

In addition, the withholding formula was revised to allow a degree of over-withholding. This was felt to be desirable since "taxpayers who are due a refund have an incentive to file a tax return."[1/] In addition to encouraging compliance, overwithholding also has the advantage to the state of providing an interest free float from undistributed income tax refunds. In 1979 this float totaled nearly $210 million.[2/] With minor exceptions, the income tax as legislated in 1972 remains with us today.

The Drift From Conformity

One significant development in the state income tax since 1972 has been a steady drift away from conformity with the federal system with regard to the standard deduction and exemptions, as Congress further increased these provisions. Since higher exemptions and standard deductions reduce the tax base, states which had adopted conformity found their revenues threatened. State policymakers found a fundamental tension between the desirability of conformity and the need to protect state revenues. At first Virginia continued to conform to the level of the federal standard deduction as Congress raised it, despite slight revenue losses. However, when Congress further increased the standard deduction in 1975, Virginia legislators felt that continued conformity to the federal level would take too large a bite from state revenues. Consequently, Virginia standard deductions were temporarily frozen at their 1974 levels. In the same year a new federal Tax Reform Act raised the standard deduction yet again, and Virginia permanently fixed its standard deduction at the 1974 level.[3/] In 1977 the federal Tax Reduction and Simplification Act replaced the standard deductions with Zero Bracket Amounts (ZBAs) and in 1978 the ZBAs were increased.[4/] Through all these changes Virginia maintained its 1974 standard deduction. Also, Virginia exemptions remained fixed at $600, while the size of the federal exemptions have grown.

In sum, Virginia has half-moving base conformity (Virginia still generally follows federal AGI and itemized deductions) and half-fixed base (standard deductions and exemptions are set and do not increase with federal changes). Virginia, by starting with federal AGI and then establishing the level of exemptions and standard deductions, follows the practice of a number of other states (see Chapter 5). Difficulties resulting from the fixed level of the Virginia exemptions and standard deduction, particularly with regard to the level of low income relief, are discussed in Chapter 4.

1/ Virginia Department of Taxation, Suttenfield, "Issues," p. 72.

2/ Ibid., p. 75.

3/ Ibid., pp. 9-11.

4/ For further discussion of federal zero bracket amounts see Chapter 4.

Other Changes Since 1972

Although the drift from conformity has certainly been the most significant change in the tax in recent years, several minor reforms will be noted.

One change is the minimum filing exception. In 1978 the General Assembly passed a law that no return need be filed by individuals or married couples with AGI less than $3,000.[1/] This provision had little effect on the number of returns filed because of the need for many low income persons to file in order to obtain withholding refunds.[2/] The new law did provide some low income tax relief, primarily to single individuals whose minimum taxable level increased from $1,900 ($1,300 standard deduction plus $600 exemption) to $3,000.

A second reform enacted was the age credit. Before 1976, Virginia provided some tax exclusions for the elderly. This system contained inequities, horizontal as well as vertical. The hortizontal inequities occurred because the level of tax relief varied with the source of retirement income. In particular, recipients of non-taxable Social Security received more tax relief than those (such as retired federal employees) whose retirement income came from taxable sources. The vertical inequities arose from the arithmetical fact that the value of an exclusion or exemption increases with an individual's tax bracket.[3/] To reduce these inequities, the General Assembly in 1976 enacted an age credit which somewhat offsets the preferential treatment of Social Security income.[4/] This approach has some difficulties of its own, which are examined in Chapter 4.

A third change in the Virginia tax law involved the child care deduction. Beginning in 1954, federal tax law allowed an itemized deduction for child and disabled dependent care.[5/] In conforming to the federal itemized deductions in 1972 Virginia also adopted this deduction, which at the time was limited to a maximum of $400 per month. In 1976, however, the federal deduction was changed into a credit in order to allow individuals who take the standard deduction to enjoy the tax relief.[6/] Virginia elected to maintain the deduction (which can

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1/ Virginia Department of Taxation, Suttenfield, "Issues," p. 55.

2/ In tax year 1977 14.1 percent of all returns reported an AGI under $3,000. In tax year 1979, after the law took effect, the percentage was virtually the same (13.3 percent). Virginia Department of Taxation, Annual Reports, selected years.

3/ This is an inherent problem with exemptions and exclusions in combination with graduated rates. For more detailed discussion of this issue see Chapter 4.

4/ Virginia Department of Taxation, Suttenfield, "Issues," pp. 56-57.

5/ Richard Goode, The Individual Income Tax, revised ed. (Washington, D.C.: The Brookings Institution, 1976), p. 155.

6/ U.S. Department of the Treasury, Internal Revenue Service, Your Federal Income Tax, 1977 Edition, p. 149.

be taken in addition to either the standard or itemized deductions), setting it at five times the federal credit.[1] To date, Virginia still uses the deduction, although in 1981 it was redefined as "equal to the amount of employment-related expenses upon which the federal credit is based...for expenses for household and dependent care services necessary for gainful employment."[2]

Summary: Modern History

Having traced the history of the income tax to the present day, let us attempt to assess the changes which have occured in it since 1926.

Historical Statistics.--Table 2.3 lists the amount of revenue produced by the Virginia income tax from fiscal years 1929 to 1981.[3] Figure 2.1, a graph of these data, illustrates the uneven growth of the income tax over this period. The following list provides information on the major developments that affected tax collections during this period.

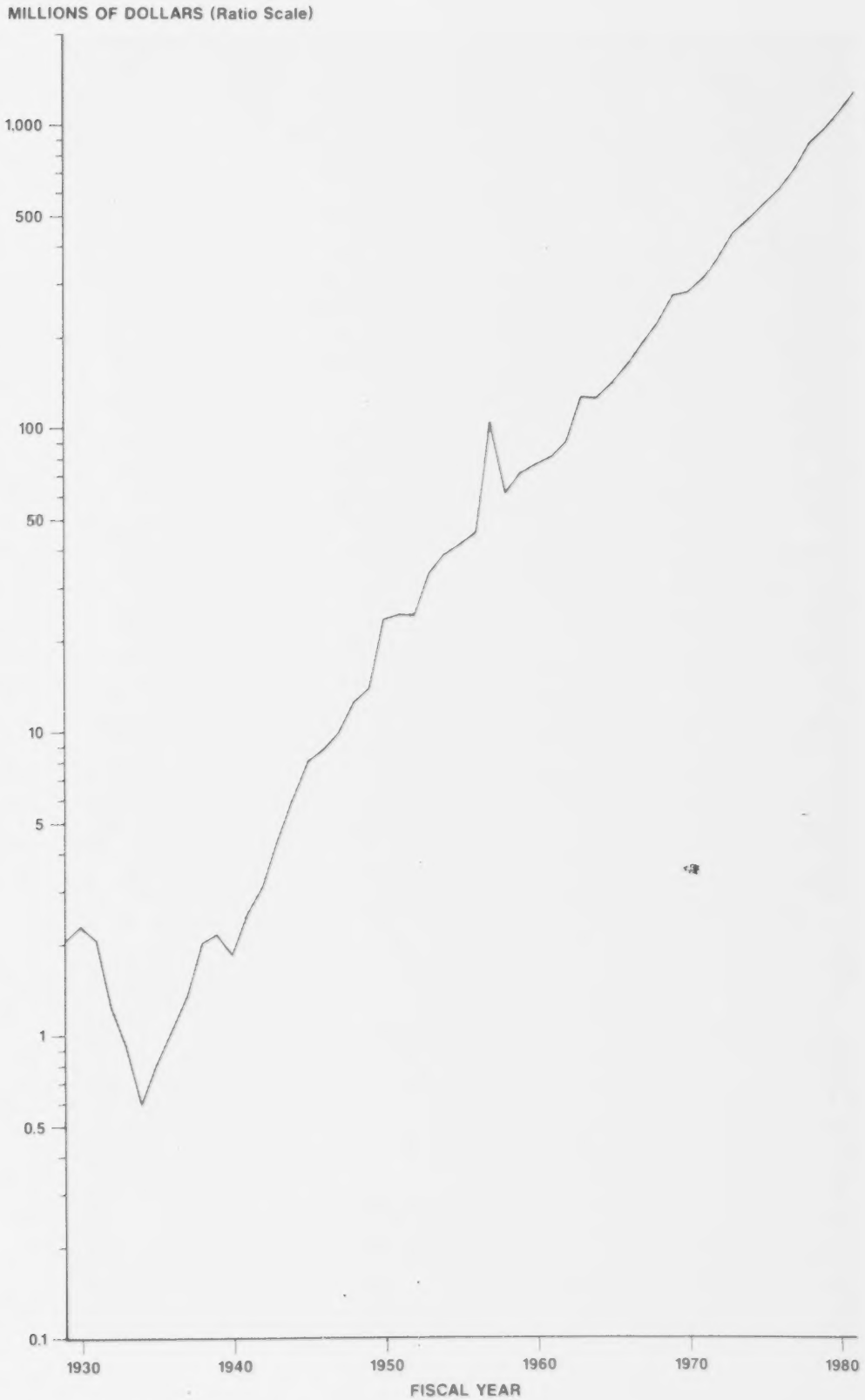
Period	Observations
1930-1934	Phase I of the Depression; declining income yields lower revenues.
1935-1937	Phase II of the Depression; resurgence of the economy increases revenues.
1938-1940	Phase III of the Depression; economy relapses into depths of the Depression; lowered revenues.
1940-1945	World War II; end of Depression, wartime expansion, and high government defense expenditures bring high income tax revenues in Virginia.
1949-1950	Revenues increase 68.3 percent after Tuck raised rates in 1948.
1950-1952	Rate of increase of income tax slows, then actually declines, after passage of Byrd Tax Credit Act.
1956-1957	One time increase of 130.9 percent in revenues after rescheduling tax payments.
1962-1963	Another one time revenue increase accompanies implementation of withholding.
1972-1973	20.9 percent increase in revenue as Virginia conforms to federal statutes and adds new upper tax bracket.

1/ Virginia, Code, Title 58, Taxation (Revised Through the 1972 Session of the General Assembly), (58-151.013(d)(4).

2/ Virginia, Code, Title 58, Taxation (Revised Through the 1980 Session of the General Assembly), 58-151.013(d)(4).

3/ Comparable data are not available before 1928.

FIGURE 2.1
VIRGINIA INDIVIDUAL INCOME TAX REVENUE,
FISCAL YEARS 1928-29 TO 1980-81



Source: Table 2.3

TABLE 2.3
VIRGINIA INDIVIDUAL INCOME TAX REVENUE
AS A PERCENTAGE OF TOTAL TAX REVENUE
FISCAL YEARS 1928-29 TO 1980-81

Fiscal Year	Income Tax Revenue Individual and Fiduciary[a] (000)	Total Tax Revenue[b] (000)	Individual Income Tax Revenue as a % of Total Tax Revenue
1928-29	$ 2,054.8	$ 27,268.6	7.5%
1929-30	2,289.2	26,903.2	8.5
1930-31	2,047.7	27,274.6	7.5
1931-32	1,250.9	25,407.5	4.9
1932-33	937.9	22,896.0	4.1
1933-34	594.3	22,352.3	2.7
1934-35	807.7	25,242.2	3.2
1935-36	1,039.4	27,997.4	3.7
1936-37	1,351.2	31,510.4	4.3
1937-38	2,016.4	33,108.9	6.1
1938-39	2,160.7	34,570.7	6.3
1939-40	1,867.0	35,771.8	5.2
1940-41	2,530.2	44,182.9	5.7
1941-42	3,085.0	52,001.9	5.9
1942-43	4,447.2	49,173.2	9.0
1943-44	6,078.9	51,089.4	11.9
1944-45	8,044.2	56,795.6	14.2
1945-46	8,890.8	63,738.0	13.9
1946-47	9,985.0	79,067.0	12.6
1947-48	12,643.4	87,728.8	14.4
1948-49	14,087.9	108,061.1	13.0
1949-50	23,716.8	121,512.3	19.5
1950-51	24,471.9	134,637.3	18.2
1951-52	24,271.7	136,581.3	17.8
1952-53	33,431.0	157,093.1	21.3
1953-54	38,737.4	162,923.1	23.8
1954-55	41,590.2	170,941.9	24.3
1955-56	45,668.2	188,687.5	24.2
1956-57	105,438.9	274,586.7	38.4
1957-58	61,431.4	215,051.3	28.6
1958-59	71,308.3	228,307.2	31.2
1959-60	76,825.2	247,924.3	31.0
1960-61	81,340.0	298,745.1	27.2
1961-62	90,951.7	311,951.7	29.2
1962-63	128,821.5	359,241.1	35.9

TABLE 2.3

VIRGINIA INDIVIDUAL INCOME TAX REVENUE
AS A PERCENTAGE OF TOTAL TAX REVENUE,
FISCAL YEARS 1928-29 TO 1980-81 (continued)

Fiscal Year	Income Tax Revenue Individual and Fiduciary[a] (000)	Total Tax Revenue[b] (000)	Individual Income Tax Revenue as a % of Total Tax Revenue
1963-64	$ 127,836.1	$ 372,268.0	34.3%
1964-65	141,756.3	403,842.0	35.1
1965-66	164,820.8	449,231.3	36.7
1966-67	192,341.7	564,940.1	34.0
1967-68	222,677.7	662,871.4	33.6
1968-69	273,430.0	847,569.5	32.3
1969-70	282,768.9	876,170.2	32.3
1970-71	312,984.1	958,860.5	32.6
1971-72	365,378.4	1,092,125.9	33.5
1972-73	441,901.0	1,300,788.1	34.0
1973-74	486,967.4	1,409,113.3	34.6
1974-75	547,125.3	1,547,494.0	35.4
1975-76	614,575.1	1,696,021.9	36.2
1976-77	714,086.3	1,921,542.3	37.2
1977-78	874,800.0	2,224,600.0	39.3
1978-79	966,600.0	2,611,200.0	37.0
1979-80	1,103,000.0	2,598,600.0	42.4
1980-81	1,288,800.0	2,864,800.0	45.0
1981-82	1,466,100.0	3,066,000.0	47.0

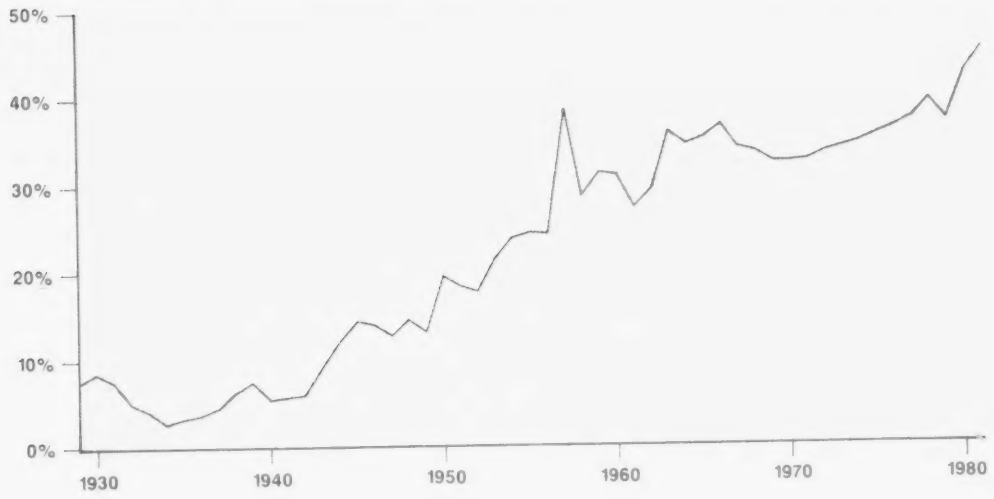
Source: Virginia Office of the Comptroller, Report of the Comptroller, selected years.

a/ Includes omitted taxes.

b/ Net of payroll tax for unemployment compensation.

Table 2.3 also shows the importance of the income tax over time by listing income tax revenue as a percentage of total tax revenue.1/ The graph of these data, plotted in Figure 2.2, indicates the growing importance of the income tax as a revenue source. In 1928-29 its share of state government tax revenue was 7.5 percent. Twenty-five years later, in 1953-54, its share was 23.8 percent, and fifty-three years later, in 1982-83, its share was 47.0 percent.

FIGURE 2.2
VIRGINIA INCOME TAX REVENUE
AS A PERCENTAGE OF TOTAL TAX REVENUE,[a]
FISCAL YEARS 1928-29 TO 1980-81



Source: Table 2.3
a Net of payroll tax for unemployment compensation.

1/ This includes all tax revenues except those from the payroll tax for unemployment compensation. This broad measure of tax revenue includes taxes in the General Fund and in special funds such as the Highway Fund.

The Politics of Reform.--One of the most powerful, if little noted, developments of the 20th century has been the rationalization of the administrative process. Of this trend, the Byrd reforms of 1926--which incorporated the first comprehensive tax plan in Virginia history and created a professional bureaucracy to enforce the new laws--are a perfect example. Nonetheless, it is important to remember the intrinsically political nature of government in general, and of taxation in particular, for the reforms of 1926 are perfect examples of this as well. These "revolutionary" reforms allowed the perpetuation of a very conservative regime. The reform of the income tax in 1926 resulted from the machine's advocacy of separation, and from the fact that the burden of the income tax fell lightly upon Harry Byrd's agrarian supporters. Similarly, the expansion of the income tax after the Second World War resulted from the refusal of the machine to impose a sales tax. Even the adoption of withholding, which would seem as pure a rationalization of the tax system as can be imagined, was associated with a one time increase in revenue which allowed the machine to postpone adoption of a sales tax.

Rates.--Rates have been low and mildly progressive. The present rate structure is essentially that of 1926, with higher rates applied to the brackets in 1948 and a new bracket added in 1972.

Administration.--The creation of a Tax Department represented a great leap forward in tax administration. Nonetheless, in keeping with Harry Byrd's opposition to a policy of centralization, the tax system retains vestiges of its earlier decentralized character. For example, local tax commissioners retain responsibility for "aiding taxpayers, providing forms, reviewing tax returns, and billing the taxpayer." The position of local tax commissioner also remained an elective one. This decentralization makes Virginia something of an anomaly among state tax systems.1/

1/ Heller and Penniman, p. 58.

CHAPTER 3
STANDARDS FOR EVALUATION

The traditional criteria for appraising taxes include equity, economic efficiency, and ease of compliance and administration. The current Virginia individual income tax and some suggested modifications to it will be evaluated against these standards.

Equity

An equitable tax system is generally considered to be based on ability to pay.[1/] Vertical equity means that those with greater ability should pay higher taxes than those with less taxable capacity. Horizontal equity calls for a system that taxes equally those with equal abilities to pay. These seem to be rather straightforward criteria. However, difficulties appear in defining and measuring taxable capacity--the tax base--and in fixing the rates to be applied to those with different abilities to pay.

Tax Base

How can one's ability to pay taxes be measured? Ideally a taxpayer's total well-being or welfare would be included. Net income, broadly defined as total accretions to wealth, is considered to be a good, though not perfect, measure of taxable capacity. A comprehensive tax base (CTB) would consist of all accrued income, defined as gross income minus the costs of obtaining income plus net capital gains.[2/] Included in the CTB would be: 1) all money income such as

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1/ See Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, 3rd ed. (New York: McGraw Hill, 1980), pp. 242-43; Edgar K. Browning and Jacqueline M. Browning, Public Finance and the Price System (New York: MacMillan Publishing Co., 1979), p. 282; and Richard Goode, The Individual Income Tax, revised ed. (Washington, D.C.: The Brookings Institution, 1976), pp. 17-20.

Another approach to equity relates the tax burden to the benefit each taxpayer receives from public services. Such an approach requires a simultaneous examination of both taxation and public expenditures. The benefit principle is useful when benefits accrue to specific individuals, rather than to society at large. In this study we use ability to pay because we are restricting our analysis to tax policy, assuming public expenditures benefit society at large.

2/ Goode p. 27. Accrued income can also be defined as consumption plus the change in net worth. For discussion of accretion income see Goode pp. 13-17; Musgrave and Musgrave, pp. 243-44, 344-47; Browning and Browning, pp. 305-6; and Henry C. Simons, Personal Income Taxation (Chicago: The University of Chicago Press, 1938), pp. 50-51, 206.

wages, salaries, interest, dividends, gifts, and government transfer payments; 2) all non-money income such as fringe benefits (e.g. employer contributions to pensions and health insurance) and in-kind government benefits (e.g., food stamps and public housing); 3) imputed income such as the value of homemaker services and the rental equivalent of owner occupied housing; and 4) appreciation in the value of realized and unrealized capital assets. Business costs need to be narrowly defined so that expenditures contributing to an individual's well-being are included in the CTB. A comprehensive tax base is needed for an equitable tax system. Otherwise those who receive income in nontaxable forms would be undertaxed, violating horizontal equity.

There are some technical difficulties involved in arriving at a CTB, including the measurement of: the monetary value of non-money income; accrued but unrealized capital gains; real as opposed to inflated capital gains and losses; and depreciation. Despite these and other difficulties in application, the comprehensive tax base elaborated here provides a useful guide in determining what to include in a broad definition of income.

Income, as noted earlier, is a good measure of taxable capacity. However, there are circumstances in which income, even broadly defined, does not accurately measure ability to pay. For example, extraordinary medical expenses or catastrophic casualty losses are generally considered to reduce taxpaying ability. In addition, size of family affects taxable capacity. If the Smith family and the Jones family have equal incomes and the Smiths are childless while the Jones have three children, the Smiths are considered to have greater taxable capacity than the Jones, and hence should pay more taxes. Finally, equity considerations indicate that those with incomes below the poverty level have minimal taxable capacity.

In sum, a fair tax base would measure ability to pay by: 1) including all income and net capital gains; 2) allowing deductions for business expenses strictly defined; 3) making adjustments to offset the inadequacy of income as a measure of ability to pay (i.e., taking account of different size families and those in special circumstances); and 4) establishing a poverty floor below which no tax would be due. Obviously this describes an ideal tax and there are many reasons why a real tax would deviate from it. However, it does provide a useful standard by which to evaluate the existing Virginia income tax and proposed changes.

Rates

Tax systems can be characterized by the way in which the effective tax rate--the percentage of income paid as tax--varies with the tax base. In a proportional tax system taxpayers at all income levels pay the same effective tax rate. In a progressive tax system the effective rate rises with income. In a regressive tax system the effective rate drops as income rises.

A flat rate applied to net income, without allowing for any exemptions, is proportional. A tax with graduated rates is progressive. A tax with a flat rate over an exempted amount is also progressive. Under this type of flat rate tax (called degressive) the effective tax rate rises with income because the fixed exemption shelters a smaller proportion of income as income increases. This allows greater amounts of income to be subject to the flat rate. Most flat rate proposals include a fixed exemption, so while the rate is flat, the resulting tax is mildly progressive rather than proportional.

Although the ability to pay principle is very helpful in defining an equitable tax base, it provides less guidance and is more controversial in constructing a fair rate structure. Vertical equity calls for taxing those with greater taxable capacity more than those with less capacity. This is sometimes interpreted to mean that those with greater capacity should pay higher marginal rates of taxation, calling for a graduated rate structure.1/ Others suggest, however, that vertical equity is provided by a flat rate tax since those with greater capacity would pay more taxes in absolute amounts. The relative advantages of graduated and flat rate structures will be discussed in the next chapter.

Efficiency

The goal of economic efficiency calls for a tax that creates minimal distortions in the market. Both the base and the rate structure affect the efficiency of a tax. If a tax is not broadly based and some types of income are not taxed, there will be an incentive to convert income into these nontaxable forms, resulting in an inefficient allocation of resources caused by tax avoidance considerations.2/ In contrast, a comprehensive tax base promotes efficiency because all forms of income are taxed, and there is no way to receive income while avoiding the tax. The level of the marginal rate may also reduce efficiency by distorting an individual's choice between additional work or leisure and changing the incentive to save and invest, as the after-tax return from such activities drops as the tax rate rises.3/

Ease of Compliance and Administration

A goal of tax policy is to reduce costs of compliance and administration as much as possible. A tax should be as simple and predictable as is feasible. Sometimes trade-offs exist among the goals of equity, efficiency, and ease of compliance and administration. A tax could be very efficient with low administrative costs--such as a head tax--but be very inequitable.4/ Policymakers need to judge trade-offs at the margin and consider whether any given increase in equity is worth the resulting economic inefficiencies and increased costs of compliance and administration. For example, many components of taxable capacity are very difficult to measure, and it may not be worth the administrative costs and added complexity to include them in the tax base. The trade-off between equity and compliance costs is also particularly relevant to the issue of state income tax conformance to the federal income tax system.

1/ The marginal rate is the rate applied to the last dollar earned.

2/ Browning and Browning, p. 306.

3/ The incentive effects of an income tax are two-fold. One is the substitution effect. Because of the reduced after-tax return, taxpayers may lower their level of work, savings, and investment. The other is the income effect. Because the tax makes people poorer, they may work harder and save and invest less.

4/ A head tax is a fixed tax per person.

CHAPTER 4

FEATURES OF VIRGINIA'S INCOME TAX

In this chapter the major components of the Virginia income tax will be analyzed, problems with the tax will be identified, and the merits of various reforms will be considered. This will be done by looking first at the tax base and then at the rate structure.

Tax Base

The tax base is equal to net income minus deductions and exemptions. Each component will be discussed in turn.

Definition of Net Income

How comprehensive is the Virginia income tax base? Virginia defines net income as federal adjusted gross income (AGI) with a few modifications. Federal AGI falls short of a comprehensive tax base (CTB). Most students of taxation agree that some types of income are properly excluded from federal AGI because they are difficult to measure (i.e., imputed rent on owner occupied housing, unrealized capital gains, and some in-kind transfers).[1/] However, many forms of income that should and could be part of a CTB are not included in federal AGI.

The most prominent example of federal tax base erosion is the widespread use of tax shelters.[2/] Tax shelters are arrangements that permit income to be sheltered or protected from taxation. Joseph Pechman notes that, "Tax shelters permit individuals to reduce drastically or even to wipe out tax liabilities on large incomes by taking advantage of preferential provisions in the tax law."[3/]

There are many types of tax shelters available. A shelter often generates substantial deductions in the early years of an investment which are used to reduce income subject to tax. The preferential treatment of long term capital gains provided by the tax code is also an important element of many tax

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1/ Edgar K. Browning and Jacquelene M. Browning, Public Finance and the Price System (New York: MacMillian Publishing Co., 1979), p. 354.

2/ See U.S. Department of the Treasury, The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals (1978), pp. 64-144; and Michael Savage, Everything You Always Wanted to Know About Taxes but Didn't Know How to Ask (New York: The Dial Press, 1979), pp. 155-229.

3/ Joseph A. Pechman, Federal Tax Policy, 3rd ed. (Washington, D.C.: The Brookings Institution, 1977), p. 119.

shelters.[1] Sixty percent of long term capital gains can be deducted in computing federal AGI. Therefore, at the time of sale of the asset, many shelters convert ordinary income into capital gains which are taxed at a lower rate because of the deduction.[2] Popular tax shelters include rental real estate, oil wells, cattle feeding and breeding, art, orchards and vineyards, and machinery and equipment leasing.[3] Tax shelters often exist not for profit, but for the tax advantages they generate. This contributes to economic inefficiency as shelters divert investment away from more productive activities that do not provide such significant tax benefits.

In addition to its use in tax shelters, the preferential treatment of capital gains reduces the comprehensiveness of federal AGI by removing from the tax base a considerable portion of income derived from the sale of capital assets. Tax treatment of capital gains is significant because it is "...a form of income that is both important in the aggregate and highly concentrated in the upper income groups."[4]

Many forms of income are not included in federal AGI because of a myriad of exclusions and deductions. These provisions serve to erode AGI as a measure of a comprehensive tax base. Excluded from federal AGI are: government transfer payments such as Social Security, railroad retirement, welfare, and veteran's benefits; fringe benefits such as employer contributions to health insurance and retirement plans; some interest earned on All-Savers Certificates; the first $100 ($200 for joint returns) of dividends; certain disability income; some unemployment compensation; and interest from state and local bonds.

Deductions allowed in arriving at federal AGI include: 60 percent of long term capital gains; some payments to Individual Retirement Accounts and Keogh retirement plans; alimony paid; limited amounts for married couples when both work; employee moving and business expenses; and business operating expenses. Some erosion of the tax base results from the loose definition of business expenses allowed by the tax code. For example, the travel and transportation deduction can be used to exclude from federal AGI expenditures for resort business conventions often only marginally related to business.[5]

1/ Long term capital gains are gains from the sale of capital assets held over one year.

2/ Conversion is that portion of the gain which reflects accelerated deductions.

3/ George F. Break and Joseph A. Pechman, Federal Tax Reform: The Impossible Dream? (Washington, D.C.: The Brookings Institution, 1975), p. 72.

4/ Break and Pechman, p. 45. See also Richard Goode, The Individual Income Tax, revised ed. (Washington, D.C.: The Brookings Institute, 1976), p. 224. In addition, a study by the Virginia Department of Taxation on the impact of Virginia's conformity to federal AGI found that the preferential treatment of capital gains adopted with conformity benefited upper income taxpayers to the detriment of middle and lower income taxpayers. See Virginia Department of Taxation, Research Division, "Virginia's Conformity to the Federal Individual Income Tax Laws: An Evaluation After Three Years," by Robert T. Benton and Elizabeth P. Martin, unpublished issue paper, 1975.

5/ U.S. Department of Treasury, President's 1978 Tax Program, pp. 182-212. See also Goode, pp. 75-96.

Some modifications to federal AGI are made by Virginia. For example, Virginia adds to federal AGI the interest earned from bonds of other states and their political subdivisions and subtracts the interest from federal obligations. Also, Virginia disallows the federal deduction for married couples when both work, because the Virginia income tax does not have a marriage penalty in its rate structure as does the federal government.[1] Other adjustments are made to the federal treatment of depreciation and retirement plan distributions. In addition, Virginia allows deduction of pensions paid by the state operated retirement system. Future modifications will be made with regard to Social Security benefits. As part of the recent Social Security reform, some Social Security benefits will be included in the federal tax base. Virginia has passed legislation to continue to exclude these benefits from state taxation.

In sum, by adopting federal AGI as the starting point for state income taxation, Virginia's tax base deviates substantially from a comprehensive tax base. How could Virginia broaden its tax base? One way would be to devise its own definition of net income by using the concept of a comprehensive tax base developed in the last chapter. Virginia did define its own tax base prior to the adoption of conformity to federal AGI in 1972. However, that base was not much broader than the current base, except that capital gains were treated as ordinary income. In order to evaluate proposals to broaden the tax base the issue of conformity must be addressed.

Conformity.--Conformity to federal AGI considerably simplifies the Virginia income tax for both taxpayers and administrators. Conformity results in easier record keeping and filing procedures for taxpayers. It also eliminates the need for detailed state laws defining income and business expenses. It allows the state to rely on federal rules, regulations, and court decisions to resolve questions of interpretation. This reduces the cost of administration and provides standard references that help insure uniform treatment of taxpayers in similar situations.[2] Administration is also simplified by the use of federal income tax data to audit returns. In sum, the advantages of conformity include simplicity, convenience, and reduced administrative costs. Currently thirty-two of the forty-one states that levy a broad based personal income tax conform in large measure with the federal Internal Revenue Code.[3]

A disadvantage of conformity is some loss of control by the state over revenues because the state's tax base is automatically tied to changes in the definition of federal AGI. However, these changes may be offset by explicit state action. Another disadvantage is that federal AGI is a deficient tax base. A more comprehensive base would improve equity. The question is whether any increase in equity resulting from a state constructed tax base would be worth the loss of the benefits of conformity. Although federal AGI deviates significantly

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1/ See later section on rates in this chapter.

2/ Virginia Department of Taxation, Research Division, "Issues for Individual Income Tax Reform in Virginia," by Nancy D. Suttenfield, Issue Paper no. 8 (1979), pp. 6-7.

3/ Twenty-two of the states use federal AGI, seven use federal taxable income, and three use federal tax liablity. Federation of Tax Administrators, Federal Starting Point Laws: State Personal and Corporate Income Taxes (Washington, D.C.: Federation of Tax Administrators, 1981), p. 1.

from a comprehensive tax base, it creates fewer inequities at the state level than at the federal level, due to the relatively low rate of state income taxation. Since the advantages of conformity are considerable, it appears that federal AGI is an appropriate tax base for Virginia.[1] Nevertheless, it might be possible to broaden the base by modifying federal AGI. It is important to note that each modification reduces the benefits of conformity. Some possible adjustments to federal AGI will be considered next.

Capital Gains.--Equitable and economically efficient treatment of capital gains is a difficult and complex task.[2] If Virginia defined its own tax base it could attempt to construct an ideal form of capital gains taxation. By conforming to federal AGI, federal tax treatment of capital gains is adopted. However, the base could be broadened by adding the capital gains deduction to federal AGI in determining Virginia AGI. The Advisory Commission on Intergovernmental Relations (ACIR) suggested this as a way to broaden the tax base of states adopting conformity.[3] In Virginia, the Revenue Resources and Economic Commission recommended full taxation of capital gains in 1975.[4] A possible problem with this approach is that it does not take into account many of the complexities of equitable capital gains taxation, such as allowing for the effects of inflation. In addition, deductions for capital losses against ordinary income would remain limited under this proposal. Most economists who call for full taxation of capital gains also suggest full deductions for capital losses. That is how Virginia dealt with capital gains and losses prior to conformity.[5] Adjusting federal AGI to allow full deductions for capital losses against ordinary income would be complicated and many of the advantages of conformity would be lost. One reason for the difficulty of deducting all capital losses in the year they occur is that under the existing federal system the yearly deduction for capital losses is limited and unused losses may be carried over and used in subsequent years to offset capital gains and ordinary income. It would be very complicated for Virginia taxpayers to extract these losses from returns of subsequent years.

1/ For a discussion of conformity see U.S. Advisory Commission on Intergovernmental Relations (ACIR), Federal-State Coordination of Personal Income Taxes, (1965); Virginia Department of Taxation, Suttenfield, "Issues," pp. 5-8; Virginia General Assembly, Virginia Income Tax Study Commission, Toward A Simplified Income Tax System, House Document No. 17, 1967; Virginia General Assembly, Income Tax Conformity Statute Study Commission, Implementation of a Simplifed Tax System System for Virginia Taxpayers, 1971.

2/ See Goode, pp. 176-211; Break and Pechman, pp. 44-57; and Pechman, pp. 106-12.

3/ ACIR, p. 23.

4/ Virginia General Assembly, Divsion of Legislative Services, Report to the Revenue Resources and Economic Commission (RREC), 1975, pp. 13-14, 27; and Barry E. Lipman and Richard D. Brown, Fiscal Prospects and Alternatives: 1976, A Staff Report to RREC, 1975, pp. 186-88.

5/ Virginia General Assembly, Toward a Simplified System, p. 17.

Minimum Tax.--The minimum tax is an indirect way to increase the comprehensiveness of a tax base. The federal government adopted a minimum tax in 1969 to ensure that at least some tax is paid by those who benefit heavily from tax preferences, i.e., preferred tax treatment for certain types of income. A number of modifications have been made in the minimum tax since 1969. In 1982 the minimum tax applied to items such as income offset by depletion, excess amortization, accelerated depreciation, and intangible drilling costs. The alternative minimum tax applied to the capital gains deduction and itemized deductions over 60 percent of AGI excluding medical expenses, casualty losses, and state and local taxes. Starting in 1983 the minimum tax has been repealed and the alternative tax has been expanded to apply to the minimum tax preference items plus the dividend and All-Savers Certification exclusions; mining exploration and development costs; circulation costs; research and experimental costs; and incentive stock options.1/ The minimum taxes do not flow through to the state through conformity to federal AGI.2/

Although the minimum tax has been criticized as weak, it is an attempt by the federal government to deal with deficiencies in its net income definition.3/ Since Virginia depends on federal AGI as its tax base, it seems reasonable for the state to also adopt federal base broadening provisions. Virginia could easily impose a minimum tax by applying a percentage to the new alternative minimum tax. Maine and Iowa already do this for the current minimum taxes. Other states that apply a minimum tax either make adjustments to the federal minimum taxes or construct their own.4/ However, making adjustments would add considerable complexity to the state tax and reduce the advantages of conformity.

Personal Deductions

Personal deductions are expenses subtracted from AGI in arriving at taxable income. Taxpayers can choose between itemizing these various deductions or taking the standard deduction. Virginia's itemized deductions conform to those of the federal government with a few modifications, such as adding back the deduction for state and local income taxes. Virginia's standard deduction does not conform to the current federal equivalent, the zero bracket amount (ZBA). Instead, it conforms to the federal standard deduction as of December 31, 1974. This section will look first at itemized deductions and then at the standard deduction.

1/ U.S. Internal Revenue Service, "Highlights of 1982 Tax Changes," Publication 553, 1982, p. 6.

2/ The minimum taxes are, however, included in the income tax base of those states that start with federal tax liability. See Chapter 5.

3/ See Goode, pp. 242-43; Break and Pechman, pp. 78-82; and Pechman, pp. 117-19.

4/ Federation of Tax Administrators, State Individual Income Tax Treatment of Federal Tax Preference Items (Washington, D.C.: FTA, 1979) and State Tax Review 44, no. 24 (June 14, 1983), p. 3.

Itemized Deductions.--There are several rationales for the use of itemized deductions. First, they provide a way to deal with special circumstances which are not always captured when income is used as a measure of ability to pay. For example, catastrophic medical bills and casualty losses are generally considered to reduce taxable capacity, and hence they can be deducted before arriving at taxable income. Second, deductions are used to promote social goods such as charitable contributions and home ownership. Third, deductions are allowed for the costs of earning income not already subtracted in computing AGI such as interest, union dues, and uniforms.

Objections to itemized deductions are that they are too generous and remove from the tax base income properly included in a comprehensive tax base. For example, the medical expense deduction is considered too broad. One reason is that difficulties exist in distinguishing between ordinary consumption expenditures and medical expenses. Also, much health care is voluntary, such as a routine physical examination, and hence not catastrophic.1/

Deductions for interest incurred in producing income are appropriate in arriving at a net income figure. However, it is often difficult to distinguish between interest paid on business debt and consumer debt. Much of the interest currently deducted is for home mortgages and consumer durables which do not produce income. Allowance for such deductions creates differences in taxable income that are unrelated to any differences in taxable capacity.

Deductions for charitable contributions can be justified as encouraging socially desirable activity. A counter-argument is that such contributions are really consumption items and as such should be taxed. Also, some oppose these deductions because they are, in effect, government subsidies to charities not chosen by the government nor under government control. Others believe the lack of government control to be a benefit.2/

Itemized deductions are also allowed for certain employee business expenses and costs of earning investment income. Entertainment expense is an itemized deduction for employees and a business deduction subtracted in computing AGI for the self-employed. A criticism of this deduction is that many luxury consumption items can be deducted such as "three-martini" lunches and dinners, country club memberships, and sports and theater tickets.3/ Deductions such as these result in understated taxable income for those who take them. Tax experts conclude that while many itemized deductions are too generous and should be tightened, a large part of these deductions are necessary to adjust income as a measure of ability to pay and to promote socially desirable activities.4/

What does this mean for Virginia? The state has several choices. First, it could define its own itemized deductions, with the resulting high costs of

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1/ As a way to limit the deduction to taxpayers with unusually high medical expenses, only expenses in excess of 5 percent of AGI can be deducted in 1983.

2/ Goode, pp. 160-62.

3/ U.S. Department of the Treasury, President's 1978 Tax Program, pp. 195-204.

4/ See Goode, pp. 145-75; and Pechman, pp. 85-90.

compliance and administration. Second, it could continue to accept most of the federal itemized deductions, reap the benefits of conformity, and accept the advantages and disadvantages enunciated above. Finally, it could eliminate itemized deductions entirely while still conforming to federal AGI. This would substantially broaden the base. However, in the opinion of many, eliminating itemized deductions would at the same time make the tax base less equitable by failing to make the adjustments to income necessary to accurately measure taxable capacity.

Standard Deduction.--Although the Virginia income tax conforms to current federal itemized deductions, its standard deduction is frozen at the federal 1974 level, which is 15 percent of federal AGI with a minimum of $1,300 and maximum of $2,000. This applies to both single persons and married couples filing jointly. For married persons filing separately the maximum and minimum amounts are halved. The Virginia General Assembly voted in 1976 to freeze the standard deduction at the 1974 level because of the revenue loss to the state that would result from conformity to the increased federal standard deduction.1/ Virginia allows taxpayers to itemize at the state level only if they itemize at the federal level.

The standard deduction was originally instituted to simplify compliance and reduce administrative costs for those with a low level of deductions.2/ The percentage amounts were used as a way to approximate the level of itemized deductions. The minimum standard deduction, also known as the low income allowance, was designed to provide a form of low income relief. The federal government has changed its standard deduction to a zero bracket amount (ZBA). ZBAs are amounts of income subject to a zero rate and are, in essence, a flat standard deduction already included in the tax rate table. The current federal ZBAs are $3,400 for married couples filing jointly, $1,700 for married persons filing separately, and $2,300 for single taxpayers. Large standard deductions benefit those in the lower middle income range because high income taxpayers tend to itemize and hence do not use the standard deduction. On the other hand, a high standard deduction reduces the equity aspects of the itemized deductions, the purpose of which is to aid those taxpayers whose income does not accurately reflect taxable capacity.

There are a number of problems, both theoretical and practical, with the existing Virginia standard deduction. First, some taxpayers are eligible for an amount of itemized deductions less than the federal ZBA but greater than the allowable Virginia standard deduction. Since they cannot itemize at the state level unless they itemize at the federal level, these taxpayers are penalized by being required to take the lower Virginia standard deduction.3/ Second, with the standard deduction frozen while itemized deductions are increasing with inflation and economic growth, the relative advantage of those who itemize is growing (see Figure 4.1). In 1981 the average itemized deduction was 4.3 times

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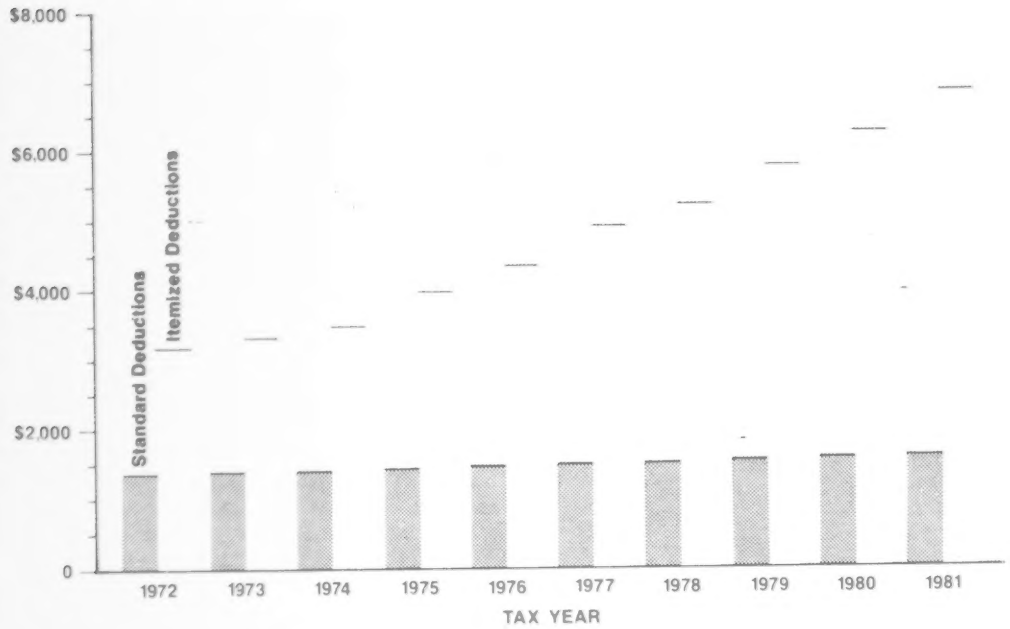
1/ Virginia Department of Taxation, Suttenfield, "Issues," p. 10.

2/ Goode, p. 173.

3/ Virginia Department of Taxation, Suttenfield, "Issues," pp. 10-11, 38-40.

FIGURE 4.1
AVERAGE STANDARD AND ITEMIZED DEDUCTIONS, 1972 TO 1981



Source: Virginia Department of Taxation, "Statistics of Income", unpublished computer printouts, selected tax years.

larger than the average standard deduction versus 2.3 times larger in 1972.1/ Third, there is a marriage penalty in the 1974 federal standard deduction adopted by Virginia. Both single taxpayers and married couples are subject to the same limits on the standard deduction. It is possible for two single earners to lose up to $2,000 of their standard deduction by marrying. There is also a marriage penalty, although a reduced one, in the current federal ZBA, as the ZBA of married couples is less than twice the ZBA of the single taxpayers. Finally, the sum of the standard deduction and the personal exemption is less than the poverty level. For a family of three, for example, the minimum standard

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1/ Derived from data in Virginia Department of Taxation, "Statistics of Individual Income by Locality for Tax Year 1972" (1974) and "for Tax Year 1981" (January 3, 1983), unpublished computer printouts:

Tax Year	(A) Average Itemized Deduction	(B) Average Standard Deduction	Ratio (A/B)
1972	$3,170	$1,364	2.3
1981	6,816	1,584	4.3

deduction of $1,300 plus $1,800 (three times the personal exemption of $600) equals only $3,100, while in 1982 the official poverty threshold for a family of 3 was $7,690.[1/] Proposals to reform the standard deduction will be considered in conjunction with the personal exemptions.

Child and Dependent Care Deduction.--Virginia allows a deduction for work-related child and dependent care expenses. This deduction is equal to the amount upon which the federal child care credit is based.[2/] The deduction is, theoretically, an adjustment in arriving at net income, viewing child and dependent care expenses as costs of earning income.

Personal Exemptions

Virginia conforms to the federal definition of personal exemptions. Both Virginia and the federal government permit personal, dependent, age, and blindness exemptions. However, Virginia allows only $600 per exemption as opposed to the $1,000 allowed by the federal tax code. Virginia provides an extra deduction of $400 for the elderly in addition to the $600 age exemption. In essence, the elderly receive the same extra tax benefit under state law that they do under federal law.

Personal exemptions are used for a number of reasons.[3/] One function of the exemption, in conjunction with the standard deduction, is to provide a poverty floor. The purpose is to remove the tax burden from those who must use all of their income to provide basic necessities and hence have no taxable capacity. A second function of exemptions is to adjust for the different abilities to pay among those with the same income but different size families. Virginia, the federal government, and a number of states also use exemptions to reduce the burden of the elderly and the blind. A third function of exemptions is to free from tax a minimum level of subsistence for all taxpayers. This reduces the effective tax rate (tax divided by AGI) for all taxpayers and adds progressivity to the rate structure.

There are several problems with the exemptions as currently established. First, even in conjunction with the standard deduction they do not provide an adequate poverty floor in terms of amount or in relation to family size. Second, in combination with Virginia's graduated rates, inequities occur because

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1/ U.S. Department of Commerce, Bureau of the Census, "Estimated Weighted Average Poverty Thresholds in 1982 (January 24, 1983)," memo provided by Carol Fendler, Bureau of the Census, February 1, 1983.

2/ See Chapter 2 for the background of this deduction.

3/ See Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, 3rd. ed. (New York: McGraw Hill, 1980), pp. 378-85; Virginia Department of Taxation, Suttenfield, "Issues," pp. 22-23; Lawrence H. Seltzer, The Personal Exemptions in the Income Tax (New York: National Bureau of Economic Research, 1968), pp. 5-6; and Eugene Steuerle, "The Tax Treatment of Households of Different Size," in Taxing the Family, ed. Rudolph G. Penner (Washington, D.C.: American Enterprise Institute, 1983), pp. 73-97.

the exemptions are worth more to those in higher marginal tax brackets than to those in lower brackets. Third, the need for special treatment of age and blindness is questionable. Fourth, because the level of the exemptions has remained constant while the income of taxpayers has increased, the tax burden of large households has grown relative to small households. Issues relating to the resolution of these difficulties will be considered next.

Poverty Floor.--There are difficulties in designing an adequate and equitable poverty floor. For example, the official poverty level varies with the size of family, but does not increase by a constant amount for each additional member (see columns 2 and 3 in Table 4.1).[1/] Also, exempting the amount of poverty level income for all taxpayers, not just those with low incomes, would result in substantial revenue loss by considerably narrowing the tax base.

Low income relief is provided by personal exemptions, the minimum standard deduction, and the minimum filing exception. Under the minimum filing provision individuals with Virginia AGI less than $3,000 and married couples with a combined Virginia AGI less than $3,000 are not required to file a return or pay any state income tax. The current level of these provisions exempt from tax only a portion of poverty level income (see columns 4 and 5 in Table 4.1).

There are a number of ways, none perfect, to establish a poverty floor. One is to construct a separate deduction, exemption, or credit only for low income persons. Examples include the California low income credit and the federal earned income credit (which has additional limitations--it applies only to earned income and to returns with dependents). Both are "vanishing" in the sense that they are gradually phased out at higher income levels so as not to penalize those taxpayers immediately above the cutoff level of income. Both exist independent of the personal exemptions and standard deduction or its equivalent. The advantage of this proposal is that relief can be provided to those with low incomes without the high cost of supplying a tax break to all. Disadvantages are that it would be administratively complicated and expensive to provide poverty level relief at a minimum and to also phase it out over higher income levels.[2/]

1/ While the Census poverty thresholds are useful benchmarks, they have some limitations. These include the fact that they do not take into account in-kind benefits received, the varying cost of living in different locations, individual taste and preferences, or special family circumstances. For further information on the poverty thresholds see U.S. Department of Commerce, Bureau of the Census, Characteristics of the Population Below the Poverty Level: 1981, Current Population Reports, Series P-60, no. 138, pp. 179-84.

2/ The Virginia minimum filing exception is not vanishing and does in fact penalize taxpayers immediately above the cut-off. Those with Virginia AGI of $2,999 are completely tax exempt, while those earning $3,001 are liable for the full amount of tax.

Another problem with the minimum filing exception is that it penalizes marriage. Since single individuals and married couples are subject to the same limit, low income individuals might lose this tax advantage if they married.

TABLE 4.1
POVERTY THRESHOLDS

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8	Col. 9	Col. 10	Col. 11
			Current Virginia		Federal ZBA amounts plus $1,500 Exemption Per Person		$3,200 Exemption Per Taxpayer and Spouse; $1,500 Dependent Exemption		Joannou Proposal[b/] $4,500 Exemption Per Taxpayer and Spouse; $0 Dependent Exemption	
Number In Family	1982 Poverty Threshold[a/]	Per Capita Change in Poverty Threshold	Minimum Taxable Level	Difference between Col. 4 and Col. 2	Minimum Taxable Level	Difference between Col. 6 and Col. 2	Minimum Taxable Level	Difference between Col. 8 and Col. 2	Minimum Taxable Level	Difference between Col. 10 and Col. 2
1	$ 4,900	$4,900	$3,000[c/]	$-1,900	$ 3,800	$-1,100	$ 3,200	$-1,700	$4,500	$ -400
2	6,280	1,380	3,000[c/]	-3,280	6,400	120	6,400	120	9,000	2,720
3	7,690	1,410	3,100[d/]	-4,590	7,900	210	7,900	210	9,000	1,310
4	9,860	2,170	3,700[d/]	-6,160	9,400	-460	9,400	-460	9,000	-860
5	11,680	1,820	4,300[d/]	-7,380	10,900	-780	10,900	-780	9,000	-2,680
6	13,210	1,530	4,900[d/]	-8,310	12,400	-810	12,400	-810	9,000	-4,210
7	14,980	1,770	5,500[d/]	-9,480	13,900	-1,080	13,900	-1,080	9,000	-5,980

a/ Source: U.S. Department of Commerce, Bureau of the Census, "Estimated Weighted Average Poverty Thresholds in 1982 (Jaunary 24, 1983)," memo provided by Carol Fendler, Bureau of the Census, February 1, 1983.

b/ Proposed legislation sponsored by Delegate Johnny S. Joannou, Virginia 1981 House Bill No. 1638.

c/ The minimum taxable level is $3,000 because of the minimum filing exception.

d/ $1,300 minimum standard deduction plus ($600 exemption x number in family).

A second way Virginia could establish an adequate poverty floor would be to adopt federal ZBA amounts--$3,400 for married couples filing jointly, $1,700 for married persons filing separately or on a combined return, and $2,300 for single persons--for its standard deduction and raise the exemption to $1,500 per person. The resulting minimum taxable income would be close to the poverty level (see columns 6 and 7 in Table 4.1). This proposal would reduce but not eliminate the existing Virginia marriage penalty in the standard deduction. Setting the single standard deduction at more than half the married amount does penalize those who are married. At the same time, however, it allows for the higher cost per capita of a single as opposed to a married person to attain a subsistence level of income.[1/] Conformance to the federal ZBA amounts would also eliminate the existing penalty for Virginia taxpayers whose itemized deductions are less than the federal ZBA amount but greater than the Virginia standard deduction and thus are forced to take the lower Virginia standard deduction.[2/] Since the federal ZBA will be indexed beginning in 1985, Virginia would have to index or periodically raise its standard deduction to keep pace with the federal ZBA. If the Virginia standard deduction conformed to the federal ZBA amounts, it would resemble an extra exemption rather than an approximation of itemized deductions, as is the case with the current percentage amount.

A third way to exempt poverty level income would be to use only exemptions--assuming standard and itemized deductions were not allowed. An exemption of $3,200 per taxpayer and spouse and $1,500 per dependent would move the minimum taxable level for different size families much closer to actual poverty thresholds than is currently the case (see columns 8 and 9 in Table 4.1). The exemptions could also be set at other levels. A bill sponsored by Delegate Johnny S. Joannou to reform the Virginia income tax calls for eliminating standard and itemized deductions and allowing an exemption of $4,500 per taxpayer and spouse and none for dependents.[3/] Columns 10 and 11 in Table 4.1 show the impact of these exemption levels. While the Joannou proposal approximates the poverty thresholds more closely than the current exemptions, it is not as close as the $3,200/$1,500 exemption proposal. The Joannou plan provides significantly more relief, relative to actual poverty thresholds, to married couples and small families than to large families.

Exemptions versus Credits.--There is some controversy over whether exemptions should be subtracted from AGI as is currently the case in Virginia and at the national level, or whether they should be replaced by credits--amounts subtracted from tax liability--as is the case in a number of states.

One view is that the criterion of ability to pay requires taxing income in excess of a subsistence level. Exemptions would then be an appropriate way to provide horizontal equity by adjusting for the different taxable capacities of families of different sizes with the same income. This view holds that each additional dependent reduces non-subsistence level income, and to calculate taxable capacity an amount equal to the size of family times the exemption should be subtracted from income. The tax should be applied to the remaining

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1/ Break and Pechman, p. 27.

2/ Virginia Department of Taxation, Suttenfield, "Issues," pp. 41-42.

3/ Virginia 1981 House Bill No. 1638.

non-subsistence income. Any desired progression could be achieved through adjustment of the rates.1/

On the other hand, exemptions seem to violate vertical equity, when used in combination with graduated rates, since they provide greater relief to taxpayers with high incomes than to those with lower incomes. This occurs because the value of a fixed exemption increases with a taxpayer's marginal rate (the rate applied to the last dollar earned). For example, the current $600 Virginia exemption reduces taxes by $34.50 ($600 x 5.75 percent) for a taxpayer in the highest bracket and only $12.00 ($600 x 2 percent) for a taxpayer in the lowest bracket. While horizontal equity calls for some differentiation in tax liability according to family size, it does not call for a differential favoring higher income taxpayers over lower. Substituting a credit for an exemption would resolve this dilemma because the amount of the credit would not vary with income. Credits would differentiate tax liabilities according to family size, satisfying horizontal equity; they would also provide the same tax reduction at all income levels, satisfying vertical equity.2/

One way to convert an exemption to a credit is to multiply the exemption by the rate applied to the lowest bracket. This gives a credit value that provides the same relief as the exemption for a taxpayer falling into the lowest bracket.3/ With a flat rate tax there is no need to convert exemptions to credits since both provide the same tax relief in all circumstances.

Special Exemptions for the Elderly and Blind.--Virginia currently gives favorable tax treatment to the blind through an additional personal exemption of $600 and individuals age 65 and older receive an additional $600 personal exemption plus an extra $400 deduction. The federal government and a number of states also provide tax breaks for the elderly and blind.

There are a number of criticisms of these extra exemptions. First, the case for special treatment is based on the idea that the minimum subsistence level

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1/ See Gerard M. Brannon and Elliott R. Morss, "The Tax Allowance for Dependents: Deductions Versus Credits" National Tax Journal 26, no. 4 (December 1973), pp. 599-610.

2/ In a variation of this view, exemptions are seen as government subsidies of certain basic costs of living and of the subsistence costs of children. As such, these subsidies are part of the social welfare system. Hence, it is unfair to provide a greater subsidy at higher income levels than at lower. The use of credits would be preferable to exemptions by making equal this subsidy at all income levels. See Thomas F. Pogue, "Deductions vs. Credits: A Comment," National Tax Journal 27, no. 4 (December 1974), pp. 659-62.

3/ The use of credits will provide less tax relief than comparable exemptions for those taxpayers who fall in higher marginal brackets. Generally, this is a good feature. However, when brackets are graduated over the lower end of the income distribution, the poverty thresholds for large families may fall into higher brackets. Since the credit is computed as the tax relief equal to an exemption at the lowest bracket, the use of credits may lower the minimum taxable income levels for large families more than would comparable exemptions.

for the elderly and blind is higher than for others. However, the poverty level for persons over 65 is lower, not higher, than that for persons under 65.[1] Second, although the blind are likely to have extra expenses, so are other taxpayers with handicaps who do not receive special tax breaks. Third, if the elderly or blind do have extra medical expenses they can deduct them as itemized deductions. Finally, neither age nor blindness is proof of financial need. Taxpayers receive these exemptions no matter what their income is. For example, at the national level more than one third of all 1978 tax returns with AGI greater than $1 million claimed an extra exemption for age.[2] The exemptions also reduce taxes more for taxpayers in higher marginal brackets than those in lower brackets. At the same time that these exemptions aid those with high incomes, they do not help the poorest elderly and blind persons who do not have any taxable income. For these reasons many analysts call for the elimination of these age and blindness exemptions.[3]

Treatment of Households of Different Size.--The level of the personal and dependent exemption has remained unchanged since 1972. In conjunction with rising incomes, this means the exemption removes a smaller portion of total income from tax. In this sense, the exemption is now functioning less well as an adjustment for taxpaying abilities of different size families with the same income.[4]

The tax burden of large households has moved closer to that of small households, as the effective rates of the former have grown much faster than the latter. Table 4.2 shows that the effective rate for a single individual increased 41.7 percent from 1972 to 1981, while the effective rate for a family of 6 grew 160.0 percent.

Age Credit

Social Security and railroad retirement benefits are currently excluded from federal AGI. This exclusion causes horizontal inequities among: a) the non-elderly; b) the elderly who do not receive such tax exempt income (principally federal civilian retirees); and c) the elderly who receive such tax exempt income. The current Virginia tax law does not address the horizontal inequity between (a) and (c). To do so would require major changes in the tax system. Inequities between (b) and (c) are addressed, but imperfectly.

1/ U.S. Department of Commerce, "Estimated Weighted Average Poverty Thresholds in 1982." In addition, Michael D. Hurd and John B. Shoven in The Economic Status of the Elderly (Cambridge, Mass.: National Bureau of Economic Research, 1982) found that during the decade of the 1970s income per household of the elderly has increased more rapidly than income per household of the rest of the population.

2/ U.S. Congressional Budget Office, Reducing the Federal Deficit: Strategies and Options, 1982, p. B-48.

3/ U.S. Congressional Budget Office, p. B-48; Virginia Department of Taxation, Suttenfield, "Issues," p. 24; and Goode, p. 222. See also Seltzer, pp. 113-20.

4/ See Eugene Steuerle, "The Tax Treatment of Households of Different Size," in Taxing the Family, ed. Rudolph G. Penner, (Washington, D.C.: American Enterprise Institute, 1983), pp. 73-97.

TABLE 4.2

TAXES FOR DIFFERENT SIZE HOUSEHOLDS EARNING THE SAME INCOME, 1972 AND 1981[a]

		Tax Liability				Effective Tax Rate			
Household size		1	2	4	6	1	2	4	6
Median AGI[b]									
1972	$10,958	$262	$232	$172	$115	2.4%	2.1%	1.6%	1.0%
1981	$23,602	$791	$756	$687	$618	3.4%	3.2%	2.9%	2.6%
% Change		202%	226%	299%	437%	41.7%	52.4%	81.3%	160.0%

Source: Computations by the authors based on a table in Eugene Steurele, "The Tax Treatment of Households of Different Size," in Taxing the Family, ed. Rudolph G. Penner (Washington, D.C.: American Enterprise Institute, 1983), p. 76.

a/ Examples assume all income earned by one spouse. Itemized expenses assumed equal to 23 percent of AGI.

b/ Virginia median AGI per married couple was used to hold constant the relative status of households being compared over the years. Note that the median AGI does not represent the median income of household units of various sizes. Median AGI found in John L. Knapp, Distribution of Virginia Adjusted Gross Income, by Income Class, 1981 (Charlottesville: Tayloe Murphy Institute, 1983), p. 4.

The best way to eliminate these inequities would be to tax Social Security benefits in full. The federal government will tax some Social Security benefits in the near future. However, Virginia will continue to exclude Social Security benefits from taxation.1/ Rather than eliminate the tax relief for Social Security recipients, Virginia uses an age credit to provide some tax relief for elderly recipients of taxable income.

The credit for taxpayers age 62 and over is based on the difference between maximum Social Security benefits and any Social Security benefits actually received.2/ It is a vanishing credit, decreasing for AGI over $12,000 and

1/ Virginia Senate Bill 358; Chapter 472, 1983 Acts of the Assembly.

2/ To simplify the discussion, we have omitted reference to Railroad Retirement Supplemental Annuities which are included in addition to Social Security benefits.

reaching zero at $16,517. More specifically, the base of the credit is equal to the maximum Social Security benefit minus Social Security received minus $2 for every $1 of AGI in excess of $12,000. The credit is equal to 5 percent of this base.[1]

Since the credit falls quickly for AGI greater than $12,000, the age credit directs tax relief to low and moderate income elderly taxpayers. However, the fact that the credit "vanishes" results in its considerable complexity. The credit currently takes eleven lines on the tax form and an entire page of instructions.

Also, the $12,000 constraint has remained constant since its enactment in 1976, while inflation, as measured by the U.S. Consumer Price Index, increased by 70 percent from 1976 to 1982. This means that many middle income elderly taxpayers are no longer eligible for tax relief. Raising the constraint would direct more tax relief to these taxpayers. In 1981 the Virginia Senate Finance Subcommittee on Retirement called for an upward adjustment in the $12,000 income constraint.[2]

The upper income limit of the credit also reduces horizontal equity among upper income taxpayers with different sources of income. For example, imagine two taxpayers, A and B. Both are 65 years old and earn the same amount of income, greater than $16,517. Let taxpayer A receive the maximum Social Security payment, while taxpayer B receives no Social Security. Taxpayer A is granted an exemption on this income, while taxpayer B, on the other hand, receives n tax break. Eliminating the $12,000 income constraint would resolve this inequity and would also reduce most of the complexity of the age credit.

Rates

The current Virgina rate structure will be examined next, and the advantages and disadvantages of graduated and flat rate structures will be considered.

Virginia Rate Structure

Rates are applied to taxable income which, as we have seen, is equal to federal AGI with modifications minus exemptions and deductions. The rate schedule can be defined as the marginal rates that apply to successive strata of incomes. The current Virginia rate structure is:

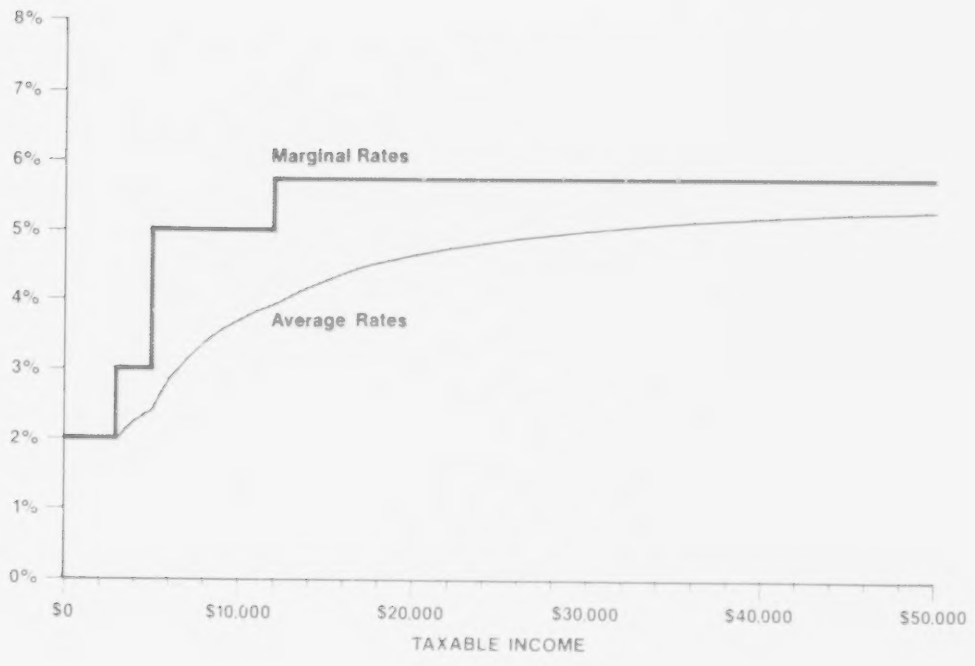
Taxable Income	Tax Rate
0 to $2,999	2%
$3,000 to $4,999	3%
$5,000 to $11,999	5%
$12,000 and over	5.75%

1/ Taxpayers who receive retirement income benefits of the state, its subdivisions, and agencies may either subtract them from federal AGI or use this credit.

2/ Report of the Virginia Senate Finance Subcommittee on Retirement, November 23, 1981.

These marginal rates can be translated into average rates by dividing tax liability by taxable income.1/ Figure 4.2 illustrates Virginia's average and marginal rates.

FIGURE 4.2
VIRGINIA INCOME TAX—AVERAGE AND MARGINAL RATES



The Virginia rate schedule applies to all taxpayers regardless of marital status. This means there is no penalty for being married or single in the Virginia rates. This is in contrast to the federal tax structure in which each filing status has a different rate schedule.

The use of the Virginia combined return, in which couples who file jointly at the federal level can compute their Virginia tax separately, allows each to take advantage of the lowest marginal rates and makes the Virginia rates neutral with regard to marriage. By using one "combined" return the state can more easily take advantage of an important benefit of conformity--better auditing by comparing Virginia returns with their respective federal returns.

1/ For example, the tax liability on a taxable income of $5,000 is $120 [2 percent x $3,000) + (3 percent x $2,000) = $120.] The average tax rate is then 2.4 percent ($120 divided by $5,000).

Calls for reforming the Virginia rate structure range from broadening the brackets over the entire distribution of income to changing to a flat rate. To judge such proposals, the merits of various rate structures will be reviewed.

Graduated Rates

There are a number of arguments in favor of a graduated rate structure. The major argument is that taxation is an effective instrument of income redistribution which should be used to reduce economic inequality in society. Even Walter J. Blum and Harry Kalven, Jr., who find the case for progressive taxation "uneasy," note that:

> By using the tax system for redistribution, the market, at least within large limits, can be left to determine relative values and allocate resources through the price mechanism, with the freedom of individuals left relatively unimpaired, with no significant addition to government manpower, and with no increase in difficult discretionary judgments which government personnel need make.[1/]

Boris I. Bittker observes that: "Progressive tax rates, in my view, fit comfortably within...democratic capitalism."[2/]

Second, ability to pay is cited as justification for graduated rates. Some interpret this concept to mean that upper income taxpayers have a greater ability to pay higher rates than lower income taxpayers. The last dollar of income earned is considered to be less valuable to high income individuals than to those with lower incomes. This marginal utility of income concept is considered by others to be too subjective to use as a basis for setting graduated rates.[3/]

Third, it is argued that upper income taxpayers should pay a higher rate because they are the ones most dependent on the protection of the government, particularly its maintenance of stability and legal order. Bittker makes this point, noting: "What good are stock certificates, or even deeds to real estate, in a society in which ownership depends on brute force?"[4/]

Fourth, an argument in favor of an unindexed graduated rate structure is that it promotes economic stabilization.[5/] During times of inflation as incomes

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1/ Walter J. Blum and Harry Kalven, Jr., The Uneasy Case for Progressive Taxation (Chicago: The University of Chicago Press, 1953), p. 72.

2/ Boris I. Bittker, "Second Lecture," in The Income Tax: How Progressive Should It Be?, by Charles O. Galvin and Boris I. Bittker (Washington, D.C.: American Enterprise Institute, 1969), p. 57.

3/ Blum and Kalven, pp. 39-70.

4/ Bittker, p. 49.

5/ Dan Tipps and Lee Webb, eds., State and Local Tax Revolt: New Directions for the 80's (Washington, D.C.: The Conference on Alternative State and Local Policies, 1980), p. 9.

rise, the effective rates also increase as taxpayers are pushed into higher brackets. This gives taxpayers less after-tax income, helps to stem inflation, and also provides more revenue to the government to meet its inflated costs. During times of depression as incomes drop, the effective rates also fall, giving taxpayers more after-tax income and serving as an economic stimulant. The magnitude and significance of this effect has been questioned.[1/] Fifth, the argument has been advanced that a progressive income tax is needed to offset the regressivity of other taxes.

Finally, some advocate highly graduated rates at the state level in order to take advantage of the federal deductibility of state income taxes. Since state income taxes are deductible in the computation of the federal income tax for those who itemize, the federal government, in effect, subsidizes the state tax. The percentage of state tax offset by the federal government depends on the taxpayer's marginal rate. If a taxpayer is in the 50 percent federal bracket, then his net cost resulting from a $1.00 increase in the state tax is only $.50, since he recoups $0.50 through a reduction in his federal tax. To maximize this offset some call for steeply graduated rates at the state level, which one writer labels "a state-initiated form of federal revenue sharing."[2/] Graduated rates would mean a lower state tax burden on lower and middle income taxpayers who generally do not itemize and a greater state tax burden on the upper income groups, who fall in the higher federal tax brackets where the federal offset would be greatest.

Critics of graduated rates focus on their complexity and the inefficiency that results from their use. Complexity stems not from the actual application of graduated rates when computing tax liability, which requires minimal effort, but from attempts to deal fairly with issues concerning the treatment of the timing of income and the family unit. With graduated rates, a large capital gain accrued over many years but realized in one year would put a taxpayer in a higher bracket than if he were taxed on the gain as it accrued each year. Reduction of the high marginal rate that would otherwise be imposed is one justification for the favorable capital gains treatment in the federal tax code that would not be applicable if the federal rates were flat. Similarly, averaging provisions in the federal tax code are complexities that attempt to provide fair treatment in a graduated rate structure for others who receive extra large incomes in one year, putting them in a higher marginal bracket.

Graduated rates also require policy decisions about the proper taxable unit--whether it should be individual, married couple, or household. Should married couples be required to file jointly and combine their income, be allowed to divide total family income between husband and wife and be taxed separately, or be permitted to have each earner in the couple compute the tax separately on his or her own income? Taxpayers may fall in different brackets depending upon

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1/ Blum and Kalven, p. 31.

2/ Edward Moscovitch, "State Graduated Income Taxes--A State-Initiated Form of Federal Revenue Sharing," National Tax Journal 25 (1972), pp. 53-64. See also Robert I. Keller, "The Case for Highly Graduated Rates in State Income Taxes," Maryland Law Review 35, no. 4 (1976), pp. 617-50.

which choice is made. The latter option is allowed in Virginia, and although this provision prevents a marriage penalty, it does mean that married couples with the same total income could have different tax burdens depending on whether there is one earner or two.[1/]

Other judgments concerning equity--such as whether a single and a married taxpayer earning the same income should pay the same rate--and concerning marriage incentives need to be made in a graduated rate structure. Complexities such as the four federal rate schedules dependent on marital status result from attempts to deal fairly with those in different circumstance. Such dilemmas occur only with graduated rates. Virginia has only one rate schedule; thus it is marriage neutral, perhaps at the cost of some equity since a married person with a family pays the same rate as a single individual, who generally has a greater ability to pay. On the other hand, the argument can be made that this is equitable since distinctions for family size are made through exemptions. The point here is that decisions concerning the appropriate taxable unit are necessary only with graduated rates. With a flat tax one cannot be pushed into a higher bracket, so these issues are irrelevant. It is important to note, however, that while graduated rates do result in some complexities, other complexities result from the definition of the tax base and could be eliminated without any need to change from graduated rates.

Critics also charge that high marginal rates lead to inefficiencies. These include a reduced incentive to work, save, and invest because of the smaller after-tax return from these activities.[2/] In addition, the quest for loopholes is accelerated with high marginal rates as it becomes more profitable to shelter income from tax as the tax bite gets larger. Schemes to transfer income from taxpayers in higher brackets to those in lower brackets, such as from parents to children, are also encouraged by the use of graduated rates. In general, the tax savings of all provisions that reduce taxable income--the capital gains deduction, exemptions, personal deductions, and exclusions--depend upon a taxpayer's marginal rate. The higher the marginal rate is, the greater the tax savings will be.

In contrast to the argument that graduated rates help moderate inflation, some believe that graduated rates penalize taxpayers during periods of inflation. As inflation raises taxpayers' incomes without increasing their purchasing power, they are pushed into higher brackets. This "bracket creep" is considered an unlegislated tax increase because, without any action, tax burdens rise faster than inflation.

1/ For example, assume the Brown and Johnson families each have total taxable incomes of $20,000. All the income is earned by one spouse in the Brown family. In the Johnson family one spouse earns $12,000 and the other earns $8,000. The Browns, computing their tax on $20,000, would owe $930. The Johnsons, on the other hand, would compute the tax on $12,000 and $8,000 separately, making their total tax only $740.

2/ See William E. Simon, Reforming the Income Tax System (Washington, D.C.: American Enterprise Institute, 1981), pp. 29-32; and Bruce Bartlett, "The Economics of Progressive Taxation," Modern Age 22, no. 3 (Summer 1978), pp. 285-92.

These criticisms of graduated rates are most applicable to a steeply graduated rate structure with high marginal rates. The current Virginia rate structure is graduated only at the lower end of the income distribution and at relatively low rates. Therefore, many of these criticisms are not applicable. For example, Virginia does not have the complexities of averaging provisions. Work, saving, and investment decisions are probably affected little by the graduation of the Virginia rates, especially since the top marginal rate is relatively low.

In addition, most work, saving, and investment decisions are probably based on federal tax provisions because of the significantly greater federal tax burden. In sum, the Virginia graduated rate structure provides tax relief at the lower end of the income scale without generating many of the distortions of high and steeply graduated rates. A rate schedule graduated at the lower end of the income distribution also serves the purpose of keeping some lower income individuals as taxpayers, which may enhance their sense of citizenship and responsibility, while imposing only a minimal burden. This is especially important since they may be receiving a number of government benefits.

Flat Rate

Most proposals calling for a flat rate actually advocate a flat rate applied to income in excess of an exempted amount. This type of flat rate tax, called degressive, will be considered here. As noted in Chapter 3, a degressive tax is in fact mildly progressive because of the exemption, as indicated by the rise in effective rates (tax divided by AGI) as AGI increases. This occurs because as AGI rises, the exempted amount falls relative to AGI, leaving a greater percentage of AGI subject to the flat rate. Under a degressive tax the average rate (tax divided by taxable income) equals the marginal rate and does not rise with taxable income. Exempting some income from tax is suggested as a way to provide low income relief.

A flat rate is supported by some because it eliminates many of the disadvantages of graduated rates.[1/] A proportional or flat rate would reduce the need for complexities such as averaging resulting from highly graduated rates, although it would not lessen the complexities resulting from the definition of the tax base. The work, saving, and investment disincentives caused by high marginal rates would be reduced under a flat tax for those taxpayers whose marginal rate would decrease. This effect would be limited, however, because establishment of a flat rate that would raise the same revenue as a graduated rate tax would decrease the marginal rate for some and increase it for others. While disincentives would be reduced for those with a declining marginal rate, the disincentives would increase for others with a rising marginal rate.

Another advantage of a flat rate is that inflation would not distort the brackets and "bracket creep" would be eliminated, although the level of the exemption would need to be indexed or periodically raised to keep pace with inflation. Finally, advocates consider a flat tax to be fair and to satisfy the criteria of ability to pay since higher income taxpayers pay more tax in absolute amounts than lower income taxpayers.

1/ See for example Milton Friedman, "How Flat is Flat?" Newsweek (August 2, 1982), p. 52, and Robert E. Hall and Alvin Rabushka, Low Tax, Simple Tax, Flat Tax (McGraw-Hill, 1983).

In contrast, some oppose the flat rate because they consider it unfair that higher income individuals should be subject to the same tax rate as those with lower incomes. The argument is also made that many work, saving, and investment inefficiencies result from the level of the marginal rate, not from the graduation. Therefore, a high flat rate tax would create many of the same inefficiencies and disadvantages as a graduated rate structure with high marginal rates.

In addition, enactment of a flat rate to replace an existing graduated rate structure would probably increase the effective rate for middle income taxpayers. This would occur because the burden on those with lower incomes would be reduced or eliminated because of the exemption, while the burden on upper income groups would be cut due to the lowering of the rate. The burden on the middle income group would therefore have to increase in order to raise the same amount of revenue.1/

Finally, just as most of the disadvantages of graduated rates apply to the federal tax, so too are the arguments for a flat rate more persuasive at the federal level than at the state level. Since the Virginia graduated rate structure does not have significant disadvantages, changing to a flat rate would not have much impact on complexity or efficiency of the income tax. A flat rate would, however, redistribute the tax burden.

Setting the Rate Structure

Setting the level of a flat rate tax is fairly easy since there are only a few variables. The personal exemptions can be set to exclude poverty level income, then the rate can be adjusted to raise a given amount of revenue.

Establishing a graduated rate structure is considerably more complicated. Decisions need to be made concerning the number of brackets, the level of each bracket, and the rate to be applied to each bracket. Unfortunately, there are no economic principles one can look to for guidance in making these decisions. This difficulty was one reason Professor J. R. McCulloch opposed graduated rates in 1865:

> The moment you abandon, in the framing of such taxes, the cardinal principle of exacting from all individuals the same proportion of their income or property, you are at sea without a rudder or compass, and there is no amount of injustice or folly you may not commit.2/

1/ Joseph J. Minarik, "What's In Store for the Income Tax?" Challenge (November-December 1982), p. 22.

2/ J. R. McCulloch, A Treatise on the Principles and Practical Influence of Taxation and the Funding System (London: Scottish Academic Press, 1975), p. 147, quoted in Bartlett, p. 288.

Nevertheless, policymakers can make reasonable judgments based on equity considerations concerning the desirable degree and level of graduation.

For Virginia there are a number of options. First, the state could continue using its present mildly progressive brackets and increase the rates if needed. Second, one or more brackets could be added to the top of the existing brackets to make the rate schedule more steeply progressive. Third, Virginia could start from scratch and set up new brackets based on the distribution of income.

In order to use the distribution of income as a basis for setting brackets, a few issues need to be resolved. The first issue involves the selection of a measure of income. Since taxable income determines a taxpayer's bracket, taxable income is the relevant income to use. If there are no exemptions or deductions, AGI would equal taxable income and the distribution of AGI could be used. If exemptions and/or deductions are allowed, the distribution of taxable income could be estimated by using the distribution of AGI and then subtracting an approximation of exemptions and deductions.

A second question is which distribution to use--by household, family, taxpayer, or return? Distribution by taxpayer seems a good choice since each taxpayer (except two-earner married couples that file joint returns) has his own taxable income that is used to determine the bracket in which he falls. The number of returns is a fairly good measure of the number of taxpayers, although it understates the amount. This occurs because each combined return is counted as one by the Department of Taxation, when it actually contains two taxpayers, each possibly falling into a different brackets.

While the number of brackets is an arbitrary determination, keeping the number fairly low would reduce the complexity and the disincentives taxpayers would face if there were many brackets into which they would frequently move as their income rose.

Based on the preceding analysis, we now attempt to quantify some brackets. One approach is to assume a tax system without exemptions and deductions with four brackets desired. Using the 1981 quartile distribution of AGI for all returns,[1/] interpolating within income classes, and rounding to the nearest thousand, we would have the following:

Quartile	Income
1	$ 0 to $6,999
2	$7,000 to $13,999
3	$14,000 to $25,999
4	$26,000 and over

Another approach is used for a system that does allow exemptions and deductions. To estimate the quartile distribution of taxable income in such a system, the above distribution could be used with modifications. Since taxable income equals AGI minus exemptions and deductions, the above distribution could be adjusted by subtracting estimated exemptions and deductions, with the amount subtracted dependent on the features of the particular proposal.

1/ Virginia Department of Taxation, "Statistics of Income for Tax Year 1981," computer printout.

Rates for the different brackets could increase by the same absolute increment, the same relative increment, or have no numerical relationship to one another, as is currently the case. The three possibilities are illustrated below:

Type	Example
Same absolute increment of 2 percentage points	2%, 4%, 6%, 8%
Same relative increment of 50 percent	2%, 3%, 4.5%, 6.75%
No numerical relationship	2%, 3%, 5%, 5.75%

The amount of the initial rate also needs to be decided. If it is set low, then increments between the rates would be larger than those needed if a higher initial rate was selected.

Indexation

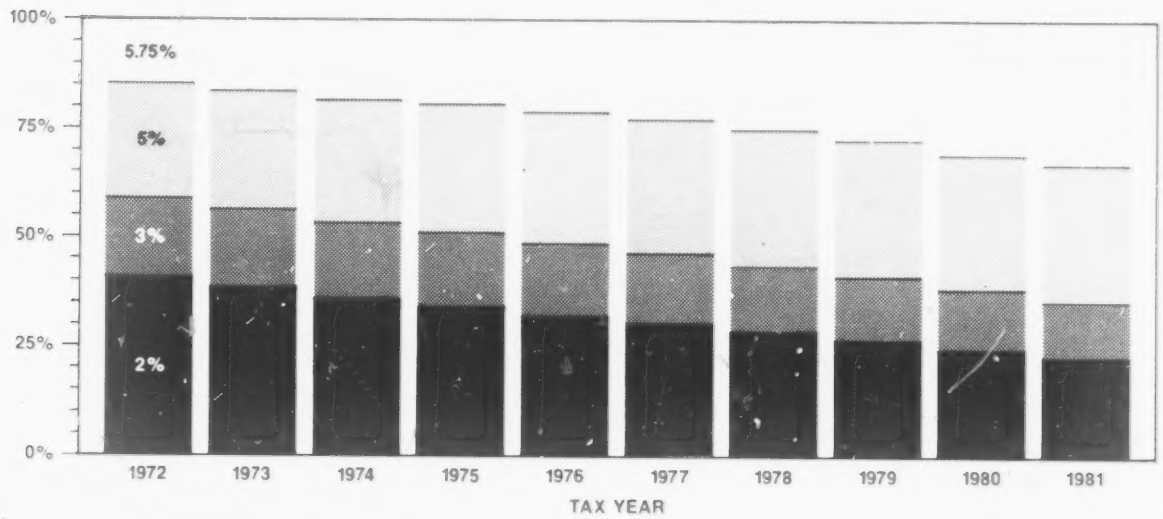
During periods of inflation the values of fixed exemptions, deductions, and credits decline. At the same time, inflated nominal incomes push more people into higher marginal tax brackets. Both effects result in higher tax liability for taxpayers whose real income remains the same. To offset these unlegislated tax increases, policymakers can periodically revise the tax structure by lowering rates or increasing exemptions and deductions. This was, in fact, the strategy adopted by the U.S. Congress during the period from the late 1960s to 1980, which saw passage of no less than seven major tax bills.[1/] Despite the implementation of conformity in 1972, Virginia has not followed the federal example. Rather than suffer a revenue loss from the new larger federal exemptions and deductions, Virginia's exemptions and deductions have been frozen at earlier federal levels. Inflation is causing Virginia's exemptions and deductions to diverge even more widely from the poverty floor (see Table 4.1) and crowding more Virginia taxpayers into the upper brackets (see Figure 4.3).

How can the inflation tax be offset? One way is periodic revision of the tax structure. Another is the use of indexation. Indexation adjusts the value of exemptions, deductions, rates, and credits based on some inflation factor. A typical indexation plan adjusts the fixed nominal features of the tax with a price index.[2/] The federal government has adopted indexation, scheduling it to begin in 1985. Indexation of the Virginia income tax would update the many features of the income tax that have been rendered anachronistic by inflation.

1/ Major recent changes in the federal income tax were incorporated in the Tax Reform Act of 1969, the Revenue Act of 1971, the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Tax Reduction and Simplification Act of 1977, the Revenue Act of 1978, and the Reagan tax cuts of 1980.

2/ For a more in-depth discussion of indexation see John L. Knapp and Philip J. Grossman, Virginia Issues: Indexing the Individual Income Tax, Virginia Issues No. 4 (Charlottesville: Tayloe Murphy Institute, 1981).

FIGURE 4.3
PERCENTAGE OF VIRGINIA TAXABLE INCOME TAXED AT EACH RATE, 1972 TO 1981



Source: Virginia Department of Taxation, "Statistics of Income", unpublished computer printouts, selected tax years.

Local Income Taxes

The income tax has several attractions as a source of local revenue. First, it provides revenues that increase with inflation. Second, it embodies the ability to pay principle and is easily adjusted to personal circumstances of taxpayers. Third, it "...allows a reasonably close correspondence between tax liability and benefits received from local public services."[1/] Fourth, it seems to be a fairly stable revenue source.[2/]

The difficulties with the local income tax, on the other hand, are threefold. First, in Virginia the income tax has traditionally been reserved for the state government. This division has been based on the argument that the different levels of government should have unique tax sources[3/] and that the state government is the most appropriate level to impose a tax which can be used to redistribute income. Second, most localities find the administrative costs of

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1/ James D. Rogers, "Sales Taxes, Income Taxes, and Other Revenues," in Management Policies in Local Government Finance, eds. J. R. Arsonson and Eli Schwartz (Washington, D.C.: International City Management Association, 1981), p. 166. This enumeration and much of the discussion in this section is adapted from Rogers, pp. 165-73.

2/ The stability of the local income tax is a counter-intuitive result, since one might expect the tax to be fairly sensitive to cyclical fluctuations in income.

3/ For a further discussion of this point see Chapter 2.

taxing property income prohibitive and therefore exempt income from this source.[1] Such a policy not only reduces the tax base (and hence revenue), but also tends to make the tax regressive since property income is concentrated in the upper classes. The obvious solution to the problem is to define the tax base as state AGI with minor adjustments, and allow the state to administer the tax. Such a tax is often called a "piggyback" local income tax. In Maryland, for example, there is a local piggyback tax, and both the state and the local tax are collected using the same form. The defect of the centralized piggyback income tax is that it diminishes local fiscal autonomy.

The third difficulty with the local income tax is the issue of how to handle non-residents who work in the locality. Non-residents as well as residents are taxed by most localities imposing an income tax, and a complex system of credits to prevent double-taxation of commuters is used. It is possible to argue against taxation of non-residents on the basis of the administrative cost of these credit schemes alone. In Virginia, the contiguity of Washington, D.C. adds a political twist to the case against taxation of non-residents. By federal law, Washington cannot impose taxes on non-residents; Virginia has reciprocated by not taxing residents of Washington who work in Virginia. For years, however, the District has been asking Congress to repeal the prohibition on taxation of non-residents.[2] If Virginia unilaterally permits its localities to tax incomes of non-residents, the District's case before Congress may be strengthened. And if both the District and Virginia tax commuters, there is a strong likelihood that the state of Virginia would lose tax revenue because of the need to provide credits for District taxes paid by Virginia commuters. Here the example of Maryland may provide a simple solution to a complex problem--Maryland limits its local piggyback income tax to residents and avoids the problem entirely.[3] In conclusion, if a local income tax is to be instituted it would be most efficient to have a piggyback tax administered by the state and applied only to residents of the locality.

Summary

A number of issues and policy options have been raised with regard to the Virginia individual income tax. 1) Deficiencies in federal AGI, which Virginia has adopted, were noted, and the benefits and drawbacks of conformity were discussed. If conformity is kept, full taxation of realized capital gains and adoption of a minimum tax were considered as ways to broaden the base. 2) A number of problems with personal itemized deductions were reviewed and the option to either keep or eliminate the use of itemized deductions was examined. 3) Some difficulties with the standard deduction were examined. These include a significant marriage penalty and a penalty for those taxpayers whose itemized deductions are less than the federal ZBA but greater than the Virginia standard

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1/ Property income includes rental income, capital gains, dividends, and interest.

2/ For background on this topic see John L. Knapp, Fiscal Prospects and Alternatives (Richmond: Division of State Planning and Community Affairs, 1971), p. 317.

3/ Rogers, p. 167.

deduction who must take the lower Virginia standard deduction. Also, because the standard deduction is frozen at the 1974 federal level while itemized deductions are rising with inflation and economic growth, there is an increasing disparity between taxpayers who itemize and those who do not. In addition, it was noted that the standard deduction plus exemptions do not provide adequate tax relief for those with less than poverty level income. Policy options include significantly raising the level of exemptions and the standard deduction and/or adopting federal ZBA amounts for the standard deduction. 4) Other problems with the exemptions were considered, including the fact that exemptions are worth more to those in high marginal brackets than those in lower brackets. The use of credits was explored. The relative increase in the tax burden of large households was also noted. 5) The equity of the special exemptions for age and blindness and of the age credit was questioned. Also, the complexity of the age credit was noted. Policy options include eliminating the special age and blindness exemptions and simplfying the age credit. 6) The many advantages and disadvantages of different rate structures were considered. Policy options include the use of flat or graduated rates and the different ways to graduate these rates. 7) The need to index features of the tax was reviewed. 8) The merits of a local piggyback income tax were explored.

CHAPTER 5
COMPARISONS OF STATE INCOME TAXES

Forty states and the District of Columbia impose broad based individual income taxes. Seven states--Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming--have no personal income tax at all, while New Hampshire and Tennessee tax only interest and dividends, and Connecticut taxes only dividends and capital gains. The discussion in this chapter is limited to those forty states and the District of Columbia that have broad based income taxes.

Tax Base

Starting Point For Computing Tax[1/]

Most states base their tax on the federal Internal Revenue Code. This is done in a variety of ways (see Table 5.1). Twenty-two states, including Virginia, use federal AGI as the starting point of their tax base. Seven begin with federal taxable income, so they adopt not only the federal definition of AGI, but also the federal provisions concerning exemptions and itemized deductions. Three states base their tax on federal tax liability, which means they incorporate, in addition to federal taxable income, the federal rate structure, credits, and minimum taxes. With all of these approaches the states do make a number of modifications to the federal provisions.

States have adopted the Internal Revenue Code as it stood at different dates. Eighteen of the thirty-two states with a federal starting point, including Virginia, conform to the current Internal Revenue Code. They automatically adopt any federal changes in their starting point. The other fourteen federal starting point states conform to the Internal Revenue Code as of a certain date. This means that changes in their federal starting points are not automatically adopted. Most of these states periodically update their Internal Revenue Code reference. Nine states do not use a federal starting point and instead construct their own.

1/ This section is based on Federation of Tax Administration (FTA), "Federal Starting Point Laws: State Personal and Corporate Income Taxes," Research Memorandum 527 (Washington, D.C.: FTA, 1981).

TABLE 5.1
STATE INDIVIDUAL INCOME TAXES: STARTING POINTS AND TREATMENT OF CAPITAL GAINS, 1981

State	Federal Starting Point Used?	Capital Gains: Holding Period	Capital Gains: Percentage Recognized	Capital Gains: Loss Credit Against Other Income	Capital Gains: Capital Loss Carryover
Alabama	No	None	100%	All	None[a]
Arizona	FAGI	1 yr.	40	$3,000	Unltd.
Arkansas	No	None	100	All	None[a]
California	No	Varies	Varies[b]	1,000	Unltd.
Colorado	FAGI	1 yr.	40	3,000	Unltd.
Delaware	FAGI	1 yr.	40	3,000	Unltd.
Georgia	FAGI	1 yr.	40	3,000	Unltd.
Hawaii	FTI	1 yr.	40	3,000	Unltd.
Idaho	FTI	1 yr.	40	3,000	Unltd.
Illinois	FAGI	None	100	All	None
Indiana	FAGI	1 yr.	40	3,000	Unltd.
Iowa	FAGI	1 yr.	40	3,000	Unltd.
Kansas	FAGI	1 yr.	40	3,000	Unltd.
Kentucky	FAGI	1 yr.	40	3,000	Unltd.
Louisiana	FAGI	1 yr.	40	3,000	Unltd.
Maine	FAGI	1 yr.	40[b]	3,000	Unltd.
Maryland	FAGI	1 yr.	40[c]	3,000	Unltd.
Massachusetts	FAGI	1 yr.	60	1,000	5 yrs.
Michigan	FAGI	1 yr.	40	3,000	Unltd.
Minnesota[d]	FAGI	1 yr.	50[b]	3,000	Unltd.
Mississippi	No	None	100	All	None[a]
Missouri	FAGI	1 yr.	40	3,000	Unltd.
Montana	FAGI	1 yr.	40	3,000	Unltd.
Nebraska	FL	1 yr.	40[b]	3,000	Unltd.
New Jersey	No	None	100	None	None
New Mexico	FTI	1 yr.	40	3,000	Unltd.
New York	FAGI	1 yr.	50[b]	3,000	Unltd.
North Carolina	No	None	100	All	None[a]
North Dakota	FTI[e]	1 yr.	50	3,000	Unltd.
Ohio	FAGI	1 yr.	40	3,000	Unltd.
Oklahoma	FTI	1 yr.	40	3,000	Unltd.
Oregon	FTI	1 yr.	40[b]	3,000	Unltd.
Pennsylvania	No	None	100	None	None
Rhode Island	FL	1 yr.	40[b]	3,000	Unltd.
South Carolina	No	1 yr.	100	All	None[a]

TABLE 5.1

STATE INDIVIDUAL INCOME TAXES: STARTING POINTS AND TREATMENT OF CAPITAL GAINS, 1981 (continued)

State	Federal Starting Point Used?	Capital Gains: Holding Period	Capital Gains: Percentage Recognized	Capital Gains: Loss Credit Against Other Income	Capital Gains: Capital Loss Carryover
Utah	FTI	1 yr.	40%	3,000	Unltd.
Vermont[d]	FL	1 yr.	40[b]	3,000	Unltd.
VIRGINIA	FAGI	1 yr.	40	3,000	Unltd.
West Virginia	FAGI	1 yr.	40	3,000	Unltd.
Wisconsin	FAGI	1 yr.	100	3,000	5 yrs.
District of Columbia[d]	No	1 yr.	40	3,000	Unltd.

Legend: FAGI: federal adjusted gross income
FTI: federal taxable income
FL: federal liability

Sources: Authors' compilation based on: Federation of Tax Administrators (FTA), "Federal Starting Point Laws: State Personal and Corporate Income Taxes," Research Memorandum 527 (Washington, D.C.: FTA, 1981), p. 4; and FTA, "State Taxation of Capital Gains," Research Memorandum 518 (Washington, D.C.: FTA, 1981), pp. 9-10.

a/ Unused capital losses may be carried over in these states through a net operating loss carry-over provision.

b/ These states levy a minimum tax on the capital gains deduction as a tax preference item.

c/ Fifty percent of adjusted federal tax preference income is added to its starting point of federal AGI.

d/ These states levy a special tax on capital gains derived from the sale of certain classes of real estate.

e/ Federal taxable income or federal liability, taxpayer's option.

Capital Gains[1/]

Tax treatment of capital gains by the states is presented in Table 5.1. Since federal capital gains provisions are applied before arriving at federal AGI, states with any federal starting point--AGI, federal taxable income, or federal liability--automatically conform to federal capital gains treatment unless they adopt specific modifications. Most federal starting point states, including Virginia, do not make any adjustment in this regard and therefore conform to federal treatment. These states are:

Arizona	Kentucky	Ohio
Colorado	Louisiana	Oklahoma
Delaware	Maine	Oregon
Georgia	Maryland	Rhode Island
Hawaii	Michigan	Utah
Idaho	Missouri	Vermont
Indiana	Montana	VIRGINIA
Iowa	Nebraska	West Virginia
Kansas	New Mexico	

The federal Internal Revenue Code allows a 60 percent deduction of net long term capital gains from gross income in arriving at AGI, permits capital losses to be offset two for one against current ordinary income up to $3,000, and provides for unlimited carry-over of capital losses. The holding period to qualify for long term capital gains is one year.

Three federal starting point states--Minnesota, New York, and North Dakota--conform to federal treatment except that they allow only a 50 percent deduction. The remaining three federal starting point states signficantly modify federal capital gains provisions. Prior to 1982, Wisconsin added back the federal capital gains deduction, although the state is phasing out this adjustment. Illinois does not distinguish between long and short term capital gains, allows no capital gains deduction or carry-over of capital losses, and permits a full offset of capital losses against current ordinary income. Massachusetts limits the capital loss offset to $1,000 of interest and dividends, allows carry-over losses only up to five years, and taxes capital gains at a different rate than certain other types of income.

The nine non-federal starting point states vary in their treatment of capital gains. The District of Columbia follows federal treatment. Alabama, Arkansas, Mississippi, North Carolina, and South Carolina follow basically the same procedure as Illinois. In California the size of the capital gains deduction depends on the length of the holding period of the asset, the offset against current ordinary income is limited to $1,000, and unlimited carry-over of losses are allowed. Finally, New Jersey and Pennsylvania do not have a capital gains deduction, permit capital losses to offset only capital gains, and do not allow any carry-over of capital losses.

1/ This section relies heavily on Federation of Tax Administrators (FTA), "State Taxation of Capital Gains," Research Memorandum 518 (Washington, D.C.: FTA, 1981).

Minimum Tax[1/]

The federal income tax includes a minimum and alternative minimum tax on "tax preferences", which are types of income receiving special tax treatment. These include long term capital gains; adjusted itemized deductions; and income offset by depletion, excess amortization, accelerated depreciation, and intangible drilling costs. The only federal starting point states that automatically include these taxes are those that start with federal tax liability. Some other states make provisions for minimum taxes. Maine employs a piggyback tax on the federal minimum taxes by imposing a tax of 15 percent of federal minimum and alternative minimum tax liability. Iowa recently enacted a minimum tax on tax preference income for individuals equal to 70 percent of the federal tax.[2/] Minnesota makes some modifications to the federal definition of tax preferences and then imposes a tax at 40 percent of adjusted federal minimum and alternative minimum tax liability. California, New York, and Oregon construct their own minimum taxes. Maryland uses a different approach. Its starting point of federal AGI is modified by the addition of 50 percent of adjusted federal tax preference income. Virginia does not impose a minimum tax.

Exemptions

All states that have a broad based income tax, except Pennsylvania, allow personal exemptions or credits (see Table 5.2). States that start with federal taxable income or tax liability automatically conform to federal exemptions unless they make specific provisions otherwise. Of the forty states allowing exemptions, six use credits and the rest use exemptions. In Table 5.2 the credits have been converted to equivalent exemptions, assuming the exemptions are deducted from the lowest brackets. The exemption equivalent ($588) of Wisconsin's $20 credit for single taxpayers is the lowest amount allowed. Virginia, along with West Virginia and Delaware, provide the next lowest exemption ($600).

Mississippi allows the highest single exemption ($6,000). The median exemption and the one most frequently used is $1,000--the same amount currently used by the federal government.

Nearly all the states, including Virginia, provide double the amount of the single exemption or credit on a married joint return. Notice, however, that doubling the credit for married joint returns does not necessarily provide double the equivalent single exemption amount.[3/]

Twenty-eight states, including Virginia, provide a dependent exemption or credit of the same size as a single one; in twelve states dependent exemptions or credits are lower.

1/ Much of this section is based on Federation of Tax Administrators (FTA), "State Individual Income Tax Treatment of Federal Tax Preference Items," Research Memorandum 489 (Washington, D.C.: FTA, 1979).

2/ State Tax Review 44, no. 24 (June 14, 1983), p. 3.

3/ This occurs because credits, unlike exemptions, do not exempt more income in higher brackets than in lower brackets. See Arkansas, Iowa, and Minnesota on Table 5.2.

TABLE 5.2
STATE INDIVIDUAL INCOME TAXES: PERSONAL EXEMPTIONS, 1982

State	Personal Exemptions[a]		
	Single	Married (Joint Return)	Dependents
Alabama	$1,500	$3,000	$300
Arizona	1,729	3,458	1,038
Arkansas[b]	17.50(1,750)	35(3,200)	6(240)
California[b]	38(3,460)	76(6,920)	12(600)
Colorado	1,203	2,406	1,203
Delaware	600	1,200	600
Georgia	1,500	3,000	700
Hawaii	1,000	2,000	1,000
Idaho[c]	[d]	[d]	[d]
Illinois	1,000	2,000	1,000
Indiana	1,000	1,000-2,000	500
Iowa[b]	19(2,082)	38(2,773)	14(467)
Kansas	1,000	2,000	1,000
Kentucky[b]	20(1,000)	40(2,000)	20(1,000)
Louisiana	6,000[e]	12,000[e]	1,000[e]
Maine[f]	1,000	2,000	1,000
Maryland	800	1,600	800
Massachusetts[g]	2,200	up to 5,200	700
Michigan	1,500	3,000	1,500
Minnesota[b]	67(2,505)	134(3,718)	67(979)
Mississippi	6,000	9,500	1,500
Missouri	1,200	2,400	400
Montana	940	1,880	940
Nebraska	[d]	[d]	[d]
New Jersey	1,000	2,000	1,000
New Mexico	[d]	[d]	[d]
New York	800	1,600	800
North Carolina	1,100	2,200[h]	800
North Dakota	1,000	2,300	1,000
Ohio	650	1,300	650
Oklahoma	1,000	2,000	1,000
Oregon	1,000	2,000	1,000
Pennsylvania	...	...	...
Rhode Island	[d]	[d]	[d]
South Carolina	800	1,600	800

TABLE 5.2

STATE INDIVIDUAL INCOME TAXES: PERSONAL EXEMPTIONS, 1982 (continued)

State	Personal Exemptions[a/]		
	Single	Married (Joint Return)	Dependents
Utah	750	1,500	750
Vermont	d/	d/	d/
VIRGINIA	600	1,200	600
West Virginia	600	1,200	600
Wisconsin[b/]	20(588)	40(1,176)	20(588)
District of Columbia	750	1,500	750

Sources: Authors' compilation based on Commerce Clearing House, "Income Tax Rates and Exemptions on 1982 Calendar Year Income," State Tax Reporter 43 (December 21, 1982), pp. 8-19; and U.S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1979-80 Edition, 1980, pp. 120-21.

... indicates not applicable.

a/ Additional exemptions for age, mental retardation and/or blindness are not included.

b/ Personal and dependent exemptions are allowed in the form of tax credits. With respect to the single and married (joint return) exemptions, the sum in parentheses is the exemption equivalent of the credit assuming the exemption is deducted from the lowest brackets. With respect to the dependent exemption, the sum in parentheses is the amount by which the first dependent raises the level at which a married couple becomes taxable.

c/ In addition to the personal exemptions, a $15 tax credit is allowed for each taxpayer. spouse, and dependent.

d/ Since the state tax is based on either federal taxable income or federal tax liability, in effect, federal exemptions are adopted. They are $1,000 for singles; $2,000 for married couples filing jointly; and $1,000 for dependents.

e/ These are combined personal exemption and standard deduction amounts. They are incorporated into Louisiana tax tables.

f/ These amounts do not reflect the inflation adjustment. Indexing was approved by Maine voters at the November 2, 1982 election.

g/ Exemptions are allowed against earned income.

h/ An additional exemption is allowed the spouse with the smallest income. Joint returns are not allowed.

In 1980 the great majority (35) of the states provided additional exemptions or credits based on age and/or blindness.[1/] The only exceptions were Alabama, Missouri, and Pennsylvania, which did not provide special treatment to either category; California, which limited special treatment to the blind; and Ohio and Wisconsin, which limited special treatment to the elderly. The most common practice was for the exemption or credit for age and for blindness to be equal to a single personal exemption. In Virginia, the age and blindness exemptions are equal to the single exemption of $600. There is also an additional $400 deduction for the elderly.

Personal deductions

Six states do not allow any personal itemized or standard deductions. These states include five with federal AGI as a starting point (Illinois, Indiana, Massachusetts, Michigan, and Ohio) plus Pennsylvania which constructs its own base. New Jersey permits some itemized deductions but not a standard deduction.

The states that start with either federal taxable income or tax liability automatically adopt federal itemized deductions. Virginia, while starting with federal AGI, also adopts federal itemized deductions (minus the deduction for state and local income taxes). Virginia does not allow federal income taxes to be deducted, although sixteen states do permit this deduction.[2/]

Standard deduction.--Illinois, Indiana, Massachusetts, Michigan, New Jersey, Ohio, and Pennsylvania do not permit a standard deduction (see Table 5.3). Virginia and twenty other states allow a standard deduction based on a percentage of AGI. The percentages range from 10 to 17 percent, with a maximum varying from $500 to $2,500 for single taxpayers. Thirteen states do not use a percentage, but instead allow a flat standard deduction ranging from $650 to $2,300 for single taxpayers. This includes the states that start with federal tax liability and therefore automatically adopt the federal zero bracket amounts (ZBA) of $2,300 for single taxpayers and $3,400 for married filing jointly. ZBAs are flat standard deductions built into the tax tables. Other states have adopted the ZBA amounts for their standard deductions.

The maximum standard deduction for married joint returns is twice the amount for single taxpayers in six states. Other states have a marriage penalty in their standard deductions. In twelve states the married joint return standard deduction is greater than, but not double, the single amount. In Virginia, as in fourteen other states, the maximum for married joint returns is the same as for single returns.

Rate Structure

This section will review some differences in the rate structures of state income taxes. It is important to note that statutory rates provide only a limited measure of tax burden, because of variations in the definition of taxable income to which the rates are applied. The variance in taxable income

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1/ The information on age and blindness exemptions comes from U.S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1979-80 Edition, 1980, pp. 120-21.

2/ State Tax Review 43, no. 51 (December 21, 1982), p. 4.

TABLE 5.3

STATE INDIVIDUAL INCOME TAXES: USE OF STANDARD DEDUCTION, 1981

State	Size of Standard Deduction		
		Maximum	
	Percent[a]	Single	Married (Joint Return)
Alabama	10%	$1,000	$1,000
Arizona	14	795	1,589
Arkansas	10	1,000	1,000
California	...	1,400	2,800
Colorado	...	1,335	1,335
Delaware	10	1,000	1,000
Georgia	15	2,000	2,000
Hawaii	10	1,000	1,000
Idaho	...	[b]	[b]
Illinois	...	...	...
Indiana	...	...	...
Iowa	15	1,200	3,000
Kansas	16	2,400	2,800
Kentucky	...	650	650
Louisiana	...	[c]	[c]
Maine	16	2,400	2,800
Maryland	13	1,500	3,000
Massachusetts	...	...	...
Michigan	...	...	...
Minnesota	10	2,206	2,206
Mississippi	...	2,300	3,400
Missouri	...	2,300	3,400
Montana	20	1,640	3,290
Nebraska	...	[b]	[b]
New Jersey	...	...	...
New Mexico	...	[b]	[b]
New York	17	2,500	2,500
North Carolina	10	550	[d]
North Dakota	...	[b]	[b]
Ohio	...	...	...
Oklahoma	15	2,000	2,000
Oregon	13	1,500	1,500
Pennsylvania	...	...	...
Rhode Island	...	[b]	[b]
South Carolina	10	500	1,000

TABLE 5.3

STATE INDIVIDUAL INCOME TAXES: USE OF STANDARD DEDUCTION, 1981 (continued)

State	Size of Standard Deduction		
		Maximum	
	Percent[a/]	Single	Married (Joint Return)
Utah	15%	2,000	2,000
Vermont	...	[b/]	[b/]
VIRGINIA	15	2,000	2,000
West Virginia	10	1,000	1,000
Wisconsin	...	2,300	3,400
District of Columbia	10	1,000	1,000

Sources: Authors' compilation based on U.S. Bureau of the Census, Statistical Abstract of the United States: 1982-83, 103d ed., 1982, p. 291; U.S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1979-80 Edition, 1980, pp. 122-23; and Commerce Clearing House, State Tax Guide.

...indicates not applicable.

a/ Amount of standard deduction is generally based on gross income after business expenses. The detailed provisions vary.

b/ Federal zero bracket amounts are adopted. They are $2,300 for single taxpayers and $3,400 for married taxpayers filing jointly.

c/ Louisiana combines the personal exemption and standard deduction. In effect, the federal zero bracket amounts are adopted.

d/ Joint returns are not allowed.

results from differences in the definition of the tax base, the size of exemptions and standard deductions, and the allowable personal deductions. The level of taxable income also depends on whether features that influence taxable income are used, such as exemptions and standard deductions, or whether features applied after taxable income, such as credits and zero bracket amounts, are used. All of these factors, not only rates, need to be examined when comparing tax burdens.

Table 5.4 lists some features of the rate structures of state income taxes. Five states--Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania--have flat rates which range from 1.9 percent to 5 percent on earned income and 10 percent on interest, dividends, and capital gains. The states that apply a flat rate to federal tax liability adopt the graduated rate structure and different schedules based on filing status of the federal tax.

Thirty-three states establish their own graduated rate structures with anywhere from two brackets (New Jersey and Mississippi) to twenty-four brackets (West Virginia). Virginia uses only four brackets, which is less than the median of seven brackets. The highest taxable income bracket in Virginia starts with income over $12,000. The median top bracket level for states with graduated rates is $23,000, with a low of $3,000 (Alabama and Maryland) and a high of $200,000 (West Virginia). The rates of the highest brackets in states with graduated rates range from 2.5 percent (New Jersey) to 16 percent (Minnesota), with Virginia's 5.75 percent rate less than the median of 7.5 percent.

Tax treatment of the family unit differs among the states. Community property states and some others require those who file joint returns to split total income and pay twice the tax on half the income. Some states follow the federal practice of establishing different rate schedules dependent on filing status, such as single, married separate, married joint, and head of household. However, most states, including Virginia, have only one rate schedule.

Indexing

The federal government and a number of states have adopted indexing of various features of their income taxes. Features indexed include brackets, standard deductions, personal exemptions, and credits. As of 1981 nine states--Arizona, California, Colorado, Iowa, Minnesota, Montana, Oregon, South Carolina, and Wisconsin--had adopted some form of indexing.[1/] In 1982, Maine voters approved an initiative to index tax rates and exemptions.[2/] When indexing of the federal income tax goes into effect in 1985, states starting with federal taxable income or tax liability will automatically adopt some federal indexing provisions (exemptions for the former and exemptions, ZBA, and brackets for the latter) unless they have made specific modifications. The Virgina income tax does not include any indexing provisions and, since it does not start with federal taxable income or tax liability, will not automatically adopt federal provisions for indexing.

1/ John L. Knapp and Philip J. Grossman, Virginia Issues: Indexing the Individual Income Tax (Charlottesville: Tayloe Murphy Institute, 1981), p. 54.

2/ Tax Foundation, "State Tax Action in 1982," Tax Review XLIII, no. 7 (November-December 1982), p. 34.

TABLE 5.4

STATE INDIVIDUAL INCOME TAXES: RATE STRUCTURE FOR SINGLE INDIVIDUALS, 1982

State	Number of Brackets	Highest Taxable Income Bracket: Amount Over ($)	Rate of Lowest Bracket (%)	Rate of Highest Bracket (%)	Rate Schedules Differ Depending on Filing Status and/or Joint Returns Required to Split Income
Alabama	3	$ 3,000	2%	5%	Yes
Arizona	7	6,000	2	8	Yes
Arkansas[a]	6	25,000	1	7	No
California	11	24,200	1	11	Yes
Colorado[b]	11	14,153	2.5	8	No
Delaware	13	50,000	1.4	13.5	No
Georgia	6	7,000	1	6	Yes
Hawaii	11	30,800	2.25	11	Yes
Idaho	6	5,000	2	7.5	Yes
Illinois	Flat rate		2.5	2.5	No
Indiana	Flat rate		1.9	1.9	No
Iowa	13	76,725	0.5	13	No
Kansas	8	25,000	2	9	Yes
Kentucky	5	8,000	2	6	No
Louisiana	3	50,000	2	6	Yes
Maine	8	25,000	1	10	Yes
Maryland	4	3,000	2	5	No
Massachusetts	Flat rate		[c]	[c]	No
Michigan	Flat rate		4.6	4.6	No
Minnesota	12	36,632	1.6	16.0[d]	No
Mississippi	2	5,000	3	4	No
Missouri	10	9,000	1.5	6	No
Montana	10	41,100	2	11	No
Nebraska	[e]	[e]	[e]	[e]	[e]
New Jersey	2	20,000	2	2.5	Yes
New Mexico	19	100,000	0.5	6.0	Yes
New York	13	23,000	2	14[f]	No
North Carolina	5	10,000	3	7	No
North Dakota[g]	6	30,000	1	7.5	No
Ohio[h]	8	100,000	0.5	5	No
Oklahoma[i]	7	7,500	0.5	6	Yes
Oregon	7	5,000	4.2	10.8	Yes
Pennsylvania	Flat rate		2.2	2.2	No
Rhode Island	[j]	[j]	[j]	[j]	[j]
South Carolina	6	10,000	2	7	No

TABLE 5.4

STATE INDIVIDUAL INCOME TAXES: RATE STRUCTURE FOR SINGLE INDIVIDUALS, 1982 (continued)

State	Number of Brackets	Highest Taxable Income Bracket: Amount Over ($)	Rate of Lowest Bracket (%)	Rate of Highest Bracket (%)	Rate Schedules Differ Depending on Filing Status and/or Joint Returns Required to Split Income
Utah	6	3,750	2.75	7.75	Yes
Vermont	k/	k/	k/	k/	k/
VIRGINIA	4	12,000	2	5.75	No
West Virginia	24	200,000	2.1	9.6	Yes
Wisconsin	8	51,600	3.4	10	No
District of Columbia	10	25,000	2	11	No

Source: Authors' compilation based on Commerce Clearing House, "Income Tax Rates and Exemptions on 1982 Calendar Year Income" State Tax Review 43, no. 51 (December 21, 1982), pp. 8-19.

a/ Special reduced rates apply to low income taxpayers.

b/ A 2 percent surtax on resident's dividend and interest income over $15,000.

c/ Interest, dividends, and net capital gains taxed at 10 percent. Earned income, annuities, and savings deposits interest in Massachusetts banks taxed at 5 percent. A 7.5 percent surtax is imposed.

d/ Plus 7 percent surtax.

e/ Tax is 17 percent of adjusted federal income tax liability.

f/ Maximum tax on earned income is 10 percent.

g/ Taxpayers may elect to compute their income tax at the rate of 7.5 percent of adjusted federal income tax liability.

h/ A 25 percent surtax is imposed for tax year June 25, 1982 to December 31, 1982.

i/ Separate rates are provided for taxpayers deducting federal income tax.

j/ Tax is 21.9 percent of federal tax liability with modification.

k/ Tax is 24 percent of federal income tax liability.

Measures of Tax Burden and Effort

In this section some measures of state tax policy will be compared. One indicator of income tax burden is effective tax rates for hypothetical taxpayers. Effective rates are defined as income tax liability as a percentage of adjusted gross income. Table 5.5 indicates the effective tax rate at different levels of income for a hypothetical married couple with two dependents. Figure 5.1 compares Virginia's effective rates with the median rates for the states that have broad based income taxes. Virginia's effective rates are considerably higher than the median for low income families. The Virginia family with an AGI of $10,000 has an effective rate of 1.8 percent, a rate 80 percent above the national median of 1.0 percent. As income rises, the relative disparity narrows between Virginia and the national median. At an AGI of $25,000, the Virginia rate (3.2 percent) is 39 percent greater than the U.S. median (2.3 percent). When AGI reaches $100,000, the Virginia effective rate (4.7 percent) exceeds the national median (4.5 percent) by only 4 percent. The limitation of effective rates as a measure of relative burden is that the definition of AGI varies among the states and AGI does not include all income.

Other measures of income tax burden are income tax per capita and income tax per $1,000 of personal income. By both of these measures Virginia's individual income tax burden in 1981 was greater than the national average (see Table 5.6).[1/] Compared with adjoining states, Virginia's income tax burden was higher than the burden in Kentucky, Tennessee, and West Virginia and lower than in Maryland. Relative to North Carolina, Virginia's per capita income tax was higher and income tax per $1,000 of personal income was lower.

Also shown in Table 5.6 is a measure of income tax effort. The U.S. Advisory Commission on Intergovernmental Relations (ACIR) devised a tax effort index, defining tax effort as the ratio of a state's actual tax collections to its tax capacity, with the national average equal to 100.[2/] Tax capacity for the individual income tax is defined as the total federal tax liability of a state's residents. Because of variations in fiscal responsibilities among state and local governments, the ACIR index reflects a combination of state and local government finances. In 1980 Virginia's individual income tax effort was 111.6. Thus, Virginia's effort was 11.6 percent greater than the average state. It should be noted that the national average includes states that do not apply a broad based income tax. Among the adjoining states, three (Kentucky, Maryland, and North Carolina) made even greater efforts than Virginia. Maryland has a substantial local income tax which is included in the effort index. West Virginia's income tax effort is lower than that of Virginia and below the national average. Tennessee, which has a limited tax applicable only to interest and dividends, has a very low effort index.

While this study focuses on the income tax, it is also helpful to view measures of total state and local tax burden and effort. Table 5.7 shows per capita taxes, taxes per $1,000 of personal income, and the ACIR tax effort index for all state and local taxes. All three measures show Virginia total burden at

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1/ The U.S. average includes those states that do not impose a broad based individual income tax.

2/ See U.S. Advisory Commission on Intergovernmental Relations, "Tax Capacity of the Fifty States, Supplement: 1980 Estimates" (June 1982).

TABLE 5.5

EFFECTIVE RATES OF STATE PERSONAL INCOME TAXES FOR SELECTED ADJUSTED GROSS INCOME LEVELS, MARRIED COUPLE WITH TWO DEPENDENTS, BY STATE, 1980

State	Adjusted Gross Income Level							
	$10,000	$15,000	$17,500	$20,000	$25,000	$50,000	$75,000	$100,000
Alabama	1.7%	1.4%	1.7%	2.0%	2.3%	2.7%	2.6%	2.5%
Arizona[a/]	-0.1	0.9	1.2	1.6	2.1	3.3	3.4	3.4
Arkansas	1.6	1.6	1.9	2.3	2.9	4.5	5.0	5.4
California[a/]	-1.4	0.6	0.9	1.3	1.9	4.5	6.2	7.2
Colorado	1.0	0.9	1.2	1.5	2.0	2.9	3.0	3.0
Delaware	2.4	2.3	2.9	3.6	4.4	6.5	8.1	9.2
Georgia	0.8	1.1	1.5	2.0	2.7	4.0	4.4	4.7
Hawaii	0.6	1.9	2.5	3.2	4.0	5.8	6.6	7.2
Idaho	0.1	1.3	1.9	2.5	3.4	5.0	5.5	5.9
Illinois	1.5	1.8	1.9	2.0	2.1	2.3	2.4	2.4
Indiana	1.1	1.6	1.6	1.7	1.7	1.6	1.6	1.7
Iowa	2.4	2.1	2.5	3.0	3.5	4.5	4.9	5.1
Kansas[b/]	0.7	1.1[b/]	1.1	1.4	1.8	3.0	3.2	3.4
Kentucky	2.6	1.9	2.3	2.6	3.0	3.3	3.2	3.1
Louisiana	---	---	---	---	0.3	0.7	1.0	1.1
Maine	0.4	0.6	0.8	1.1	1.9	4.6	5.9	6.7
Maryland	2.1	2.1	2.4	2.7	3.1	3.8	4.0	4.1
Massachusetts	2.5	3.0	3.4	3.6	3.9	4.6	4.9	5.0
Michigan	1.1	1.1	1.3	1.4	1.6	2.8	3.4	3.9
Minnesota	-4.3	2.8	3.5	4.5	5.5	7.3	7.4	7.4
Mississippi	---	---	0.3	0.7	1.2	2.3	2.7	2.9
Missouri	0.6	0.9	1.2	1.6	2.1	2.8	2.8	2.8
Montana	1.2	1.1	1.5	2.1	2.9	4.6	4.9	5.0
Nebraska[a/]	-0.6	0.5	0.8	0.9	1.3	2.8	3.8	4.5
New Jersey	0.4	1.4	1.5	1.6	1.7	2.1	2.2	2.3
New Mexico[c/]	-1.9	-0.7[b/]	-0.4	-0.1	0.5	2.4	3.5	4.3
New York	1.3	1.8	2.3	2.9	4.2	7.0	7.9	8.4
North Carolina	2.3	2.3	2.7	3.2	3.9	5.1	5.4	5.7
North Dakota[d/]	0.5	0.6	0.8	1.1	1.5	2.2	2.5	2.6
Ohio	0.5	0.8	1.0	1.2	1.5	2.3	2.7	2.9
Oklahoma	0.4	0.6[b/]	0.7	1.0	1.6	3.3	3.8	4.1
Oregon	2.3	2.1	2.6	3.2	4.0	5.6	6.7	7.3
Pennsylvania	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Rhode Island	0.7	1.6	1.8	1.8	2.2	3.8	5.0	5.9
South Carolina	1.6	1.6	2.0	2.6	3.3	4.8	5.2	5.5

TABLE 5.5

EFFECTIVE RATES OF STATE PERSONAL INCOME TAXES FOR SELECTED ADJUSTED GROSS INCOME LEVELS, MARRIED COUPLE WITH TWO DEPENDENTS, BY STATE, 1980 (continued)

State	Adjusted Gross Income Level							
	$10,000	$15,000	$17,500	$20,000	$25,000	$50,000	$75,000	$100,000
Utah	2.0	1.9	2.4	2.9	3.5	4.1	4.0	3.9
Vermont	0.9	1.9	2.1	2.2	2.7	4.6	6.0	7.1
VIRGINIA	1.8	2.0	2.3	2.7	3.2	4.2	4.5	4.7
West Virginia[e/]	1.4	1.3	1.4	1.6	1.9	3.1	3.9	4.5
Wisconsin[a/]	-0.6	3.4	4.1	4.7	5.5	7.0	7.6	7.9
District of Columbia	1.3	2.6	3.1	3.7	4.6	7.0	7.9	8.4
Median rate	1.0	1.4	1.8	2.0	2.3	3.8	4.0	4.5

Source: U.S. Advisory Commission on Intergovernmental Relations (ACIR), Significant Features of Fiscal Federalism, 1981-82 edition, 1983, pp. 57-58. Computations by ACIR staff based on Commerce Clearing House, State Tax Reporter.

Note: "Effective rates" are computed as the percentage that tax liability is of adjusted gross income. In computing income taxes, it was assumed that all income was from wages and salaries and earned by one spouse. In computing state income taxes at the $10,000 income level, the optional standard deductions, low income allowances, and optional tax tables were used. For the other income levels (based on deductions claimed on federal income tax returns) the following estimated itemized deductions were assumed (excluding deductions for federal or state income taxes): $15,000--$4,250; $17,500--$4,600; $20,000--$4,700; $25,000--$5,050; $50,000--$7,850; $75,000--$10,950; and $100,000--$13,165. Includes various credits enacted by the states.

--Indicates no tax liability.

a/ Negative rates result from credits allowed for consumer type taxes paid and/or property tax or renter credits. If the credit exceeds the tax liability the taxpayer can apply for a refund.

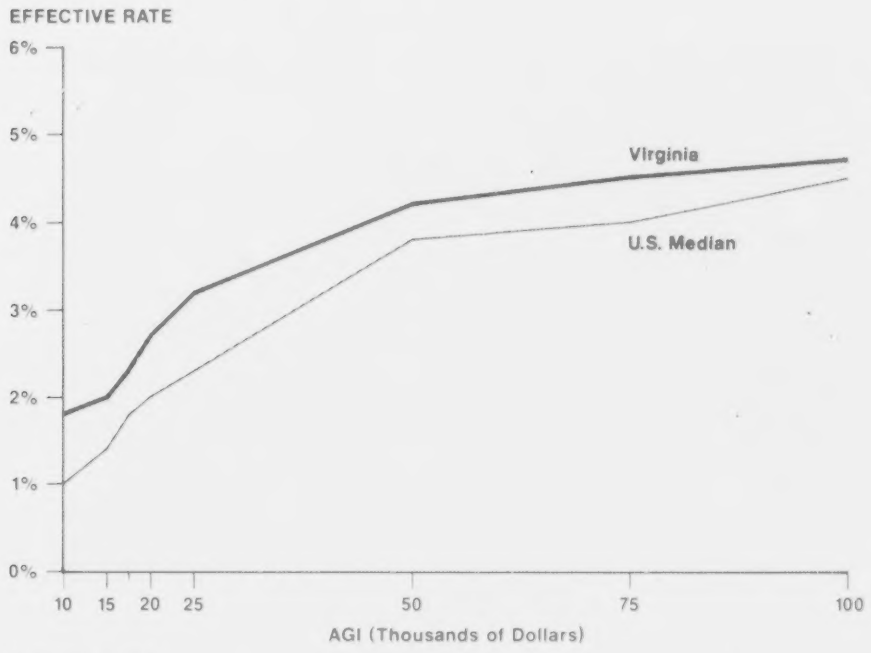
b/ In computing state tax liability at the $15,000 income level, estimated itemized deductions of $3,400 were used.

c/ In computing the state tax liabilities, estimated federal itemized deductions were used, substituting the actual New Mexico income tax liability for the estimated average state income tax liability included. The negative rates result from the food and medical tax credits.

d/ In addition to the itemized deductions indicated in the general note above, it also includes the deduction for medical expenses incurred but disallowed on the federal return because of the federal limitation.

e/ In computing tax liabilities, the itemized deductions used were federal itemized deductions, less the estimated average state income tax included.

FIGURE 5.1
EFFECTIVE RATES OF STATE PERSONAL INCOME TAXES
FOR SELECTED ADJUSTED GROSS INCOME LEVELS,
MARRIED COUPLE WITH TWO DEPENDENTS, 1980



Source: Table 5.5

TABLE 5.6
MEASURES OF STATE INDIVIDUAL INCOME TAX BURDEN AND EFFORT

	Per Capita Tax 1981	Tax Per $1,000 of Personal Income 1981	ACIR Tax Effort Index 1980[a/]		Per Capita Tax 1981	Tax Per $1,000 of Personal Income 1981	ACIR Tax Effort Index 1980
United States	$181.03	$18.97	100.0				
Alabama[b/]	132.48	17.67	86.3	Montana	185.63	21.69	115.2
Alaska[c/]	17.85	1.40	73.5	Nebraska	128.14	13.65	92.3
Arizona	133.95	15.20	66.3	Nevada	0	0	0.0
Arkansas	136.43	18.73	125.5	New Hampshire[d/]	13.71	1.50	6.6
California	278.41	25.39	135.5	New Jersey	155.85	14.22	63.1
Colorado	151.45	15.08	78.9	New Mexico	54.44	6.94	25.9
Connecticut[c/]	37.90	3.23	12.5	New York[b/]	376.60	36.60	198.6
Delaware[b/]	440.70	42.44	192.8	*North Carolina	221.62	28.31	150.0
Florida	0	0	0.0	North Dakota	95.63	10.91	55.4
Georgia	189.62	23.43	111.7	Ohio[b/]	105.06	11.08	91.6
Hawaii	347.00	34.25	180.0	Oklahoma	163.30	17.87	71.5
Idaho	196.50	24.33	136.6	Oregon	381.71	40.88	191.4
Illinois	178.31	16.92	75.1	Pennsylvania[b/]	158.86	16.80	125.8
Indiana[b/]	117.10	13.07	62.5	Rhode Island	203.74	21.50	99.1
Iowa[b/]	231.13	24.64	123.8	South Carolina	182.91	25.13	132.3
Kansas	175.54	17.55	79.5	South Dakota	0	0	0.0
*Kentucky[b/]	156.57	20.51	144.0	*Tennessee[d/]	7.77	1.00	4.7
Louisiana	44.14	5.21	34.5	Texas	0	0	0.0
Maine	156.97	19.75	102.4	Utah	201.88	26.33	143.0
*Maryland[b/]	285.87	27.27	186.0	Vermont	192.73	24.56	120.2
Massachusetts	358.71	35.34	166.0	VIRGINIA	241.04	25.61	111.6
Michigan[b/]	219.00	21.97	123.6	Washington	0	0	0.0
Minnesota	342.60	35.14	173.2	*West Virginia	137.48	17.59	89.3
Mississippi	75.83	11.50	56.5	Wisconsin	351.69	37.53	186.3
Missouri[b/]	136.21	15.13	83.7	Wyoming	0	0	0.0

Sources: U.S. Department of Commerce, Bureau of the Census, State Government Finances in 1981, GF81, No. 3, 1982, pp. 12-18, 22; U.S. Advisory Commission on Intergovernmental Relations (ACIR), Significant Features of Fiscal Federalism, 1981-82 Edition, M-135, 1983, pp. 49-53; ACIR, "Tax Capacity of the Fifty States, Supplement: 1980 Estimates" (June 1982), p. 39.

* Adjoining state.

a/ Preliminary 1980 estimates. Includes state and local income taxes.

b/ One or more local governments impose an additional local income tax.

c/ The tax applies only to capital gains and dividends of taxpayers whose federal AGI is $20,000 or more.

d/ The tax applies only to interest and dividends.

TABLE 5.7
MEASURES OF TOTAL STATE AND LOCAL TAX BURDEN AND EFFORT[a]

	Per Capita Taxes 1980-81	Taxes Per $1,000 of Personal Income 1980-81	ACIR Tax Effort Index, 1980[b/]		Per Capita Taxes 1980-81	Taxes Per $1,000 of Personal Income 1980-81	ACIR Tax Effort Index, 1980[b/]
United States	$1,079.31	$113.05	100.0				
Alabama	738.54	98.49	85.2	Montana	1,101.15	128.68	92.2
Alaska	6,397.24	500.20	166.2	Nebraska	973.93	103.74	102.2
Arizona	1,011.94	114.86	117.4	Nevada	1,102.25	102.63	59.5
Arkansas	678.43	93.16	85.5	New Hampshire	794.62	86.79	75.0
California	1,260.30	114.92	101.8	New Jersey	1,228.92	112.12	112.0
Colorado	1,024.38	101.97	90.4	New Mexico	1,099.59	140.20	83.1
Connecticut	1,198.02	101.97	99.8	New York	1,629.92	158.42	167.4
Delaware	1,125.81	108.41	88.9	*North Carolina	805.49	102.90	96.9
Florida	850.06	93.43	73.8	North Dakota	985.54	112.40	78.8
Georgia	854.09	105.53	96.2	Ohio	872.86	92.03	86.7
Hawaii	1,393.37	137.51	124.5	Oklahoma	1,009.68	110.49	71.6
Idaho	808.47	100.08	88.3	Oregon	1,106.27	118.48	93.3
Illinois	1,164.48	110.48	102.5	Pennsylvania	1,033.15	109.23	103.8
Indiana	826.94	92.32	84.2	Rhode Island	1,092.32	115.28	123.1
Iowa	1,039.34	110.82	95.7	South Carolina	776.27	106.64	95.5
Kansas	1,003.27	100.30	87.9	South Dakota	849.81	108.55	88.2
*Kentucky	787.91	103.22	88.6	*Tennessee	739.41	95.56	84.2
Louisiana	978.32	115.45	77.7	Texas	960.76	100.41	64.9
Maine	944.52	118.86	111.1	Utah	911.64	118.89	101.2
*Maryland	1,178.08	112.37	108.6	Vermont	987.44	125.85	104.2
Massachusetts	1,347.70	132.78	134.5	VIRGINIA	945.81	100.47	88.3
Michigan	1,153.31	115.68	115.6	Washington	1,037.43	100.45	93.7
Minnesota	1,169.63	119.95	111.1	*West Virginia	836.86	107.07	82.1
Mississippi	711.17	107.82	96.5	Wisconsin	1,147.38	122.44	116.3
Missouri	789.83	87.72	83.6	Wyoming	1,703.78	155.28	74.3
				*District of Columbia	1,771.24	146.88	131.2

Sources: U.S. Department of Commerce, Bureau of the Census, Governmental Finances In 1980-81 GF81, no. 5, 1982, pp. 91, 95; U.S. Advisory Commission on Intergovernmental Relations, "Tax Capacity of the Fifty States, Supplement: 1980 Estimates" (June 1982), p. 19.

* Adjoining states.

a/ For all state and local taxes.

b/ Preliminary 1980 estimates. National average = 100.

about 88 percent of the United States average, indicating that the state makes a below-average effort. Thus, although its income tax effort is above the national average, Virginia's total tax effort is lower. This occurs mainly because of the state's narrowly based general sales tax and its relatively low local property tax rates. Compared to other states in the region, Virginia's total effort index is close to those of Kentucky and Tennessee, higher than West Virginia's, and below those of North Carolina and Maryland.

The importance of the income tax as a source of tax revenue in 1981 is shown in Table 5.8. For many states the yield was significant. The income tax provided more than 30 percent of total tax revenues in twenty-one states. Oregon received the highest percentage of tax revenue from its income tax--62.5 percent. The median for all states was 27.3 percent. The Virginia income tax accounted for 42.6 percent of tax revenues, a higher percentage than in all but five states.

Local Income Taxes

In 1982 local income taxes were in effect in eleven states and the District of Columbia[1/] (see Table 5.9) and provided only 5.3 percent of local revenues in the United States.[2/] This miniscule aggregate percentage disguises the fact that many localities in the eastern half of the country--particularly those in Kentucky, Maryland, and Pennsylvania,[3/] as well as New York City[4/]--derive a significant source of their revenues from an income tax. Furthermore, in 1982 the income tax was the fastest growing source of local revenue in the country.[5/]

Almost all local income taxes are administered either by the localities themselves or by joint taxing jurisdictions comprised of several localities. The only exception to this rule is Maryland, where the tax is administered by the state.

1/ Since the District of Columbia functions like both a locality and a state, it is included in our discussion of both state and local income taxes.

2/ This figure includes the District of Columbia. U.S. Advisory Commission on Intergovernmental Relations (ACIR), Significant Features of Fiscal Federalism, 1981-1982 Edition, 1983, pp. 33, 49-53. Our enumeration does not include Oregon, which does not have a local tax per se, but where two transit authorities impose a payroll tax of 0.6 percent and 0.54 percent on the wages paid to employees.

3/ James Rodgers, "Sales Taxes, Income Taxes and Other Revenues," in J. R. Aronson and Eli Schwartz, eds. Management Policies in Local Government Finance (Washington, D.C.: International City Management Association, 1981), p. 168.

4/ Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, 3rd ed. (New York: McGraw-Hill Book Company, 1980), p. 392.

5/ ACIR, Significant Features, p. 36.

TABLE 5.8

INDIVIDUAL INCOME TAX REVENUE AS A PERCENTAGE OF TOTAL TAX REVENUE, BY STATE, 1981

	Percentage	Rank		Percentage	Rank
All States	27.3%				
Alabama	24.0	29	Montana	31.4%	17
Alaska	0.3	44	Nebraska	25.0	27
Arizona	20.4	35	Nevada	0	45
Arkansas	26.2	24	New Hampshire	4.7	42
California	32.1	16	New Jersey	22.8	31
Colorado	30.3	21	New Mexico	6.0	40
Connecticut	5.7	41	New York	47.5	2
Delaware	47.5	2	*North Carolina	38.0	9
Florida	0	45	North Dakota	13.8	36
Georgia	34.3	13	Ohio	21.6	33
Hawaii	30.8	20	Oklahoma	22.1	32
Idaho	34.6	12	Oregon	62.5	1
Illinois	27.8	23	Pennsylvania	24.8	28
Indiana	22.9	30	Rhode Island	10.6	38
Iowa	36.7	10	South Carolina	31.3	18
Kansas	29.8	22	South Dakota	0	45
*Kentucky	25.2	26	*Tennessee	1.8	43
Louisiana	6.6	39	Texas	0	45
Maine	26.2	24	Utah	34.7	11
*Maryland	40.8	8	Vermont	33.5	14
Massachusetts	47.5	2	VIRGINIA	42.6	6
Michigan	32.8	15	Washington	0	45
Minnesota	41.4	7	*West Virginia	21.1	34
Mississippi	13.7	37	Wisconsin	45.6	5
Missouri	31.3	18	Wyoming	0	45

Source: Computations based on U.S. Department of Commerce, Bureau of the Census, State Government Finances in 1981 (Washington, D.C.: U.S. Government Printing Office, 1982).

* adjoining state.

TABLE 5.9
LOCAL PERSONAL INCOME TAXES, AS OF DECEMBER 31, 1982

State	Range of Rates	Type of Rate Structure	Number of Local Governments Employing Tax
Alabama			
Municipalities	1%-2%	Flat rate	4
Delaware			
Municipalities	1%	Flat rate	1
District of Columbia	2%-11%	Graduated rates	1
Indiana			
Counties	0.5%-1%	Flat rate	3
Iowa			
School districts	[3.5% to 16% of Iowa income tax liability]		44
Kentucky			
Counties	0.25%-2.2%	Flat rate	9
Muncipalities	0.5%-1.45%	Flat rate	58
Maryland			
Counties	[20% to 50% of Maryland state income tax liability]		24
Michigan			
Municipalities	1%-3%	Flat rate	16
Missouri			
Municipalities	1%	Flat rate	2[a/]
New York			
Municipalities	0.9%-4.3%	Graduated rates	1
Ohio			
Counties	0.5%-2.25%	Flat rate	444
Pennsylvania			
Municipalities	0.25%-1%[b/]	Flat rate	2700+

Source: U.S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1981-1982, pp. 49-53.

a/ Commerce Clearing House (CCH), State Tax Guide, 15-575 to 15-589 (Chicago: CCH, 1983).

b/ With only a few exceptions, the combined income tax rate for overlapping local jurisdictions can not exceed 1 percent. Among the exceptions are Philadelphia (8.6245 percent), Pittsburgh (3.625 percent) and Scranton (2.6 percent). (17 exceptions in all.)

Local income taxes are flat in most states. Maryland and Iowa, however, have local taxes that piggyback the progressive state income tax. New York City's tax structure consists of a flat rate with sliding exemptions. Across the country the rates themselves are fairly low, varying from 0.25 percent in Pennsylvania to 4.3 percent in New York. Almost all localities tax both residents and non-residents. An exception is Maryland, which exempts non-residents.1/

1/ This section draws heavily upon Rodgers, pp. 167-69.

CHAPTER 6
OPTIONS FOR CHANGE

In Chapter 4 some problems with the Virginia income tax were reviewed and the merits of various ways of dealing with them were discussed. This chapter summarizes these arguments and incorporates them into alternative tax reform options.

Problems With The Tax[1/]

Definition of Income.--Virginia's tax base, which conforms to federal adjusted gross income (AGI) falls short as a comprehensive measure of ability to pay. Federal AGI understates taxable capacity by excluding from the tax base items such as 60 percent of long term capital gains; government transfer payments; many fringe benefits; payments to Individual Retirement Accounts; and employee moving expenses. Although federal AGI is not a perfect measure of ability to pay, the benefits to the state of conforming to federal AGI are significant. Conformity facilitates taxpayer compliance and state administration, while the task of designing and implementing a truly comprehensive tax base would be monumental. For these reasons, all of our options keep federal AGI as the starting point for Virginia's income tax.

Itemized Deductions.--Many arguments are made both in favor and against the use of itemized deductions. An objection to deductions, such as those for home mortgage interest and for charitable contributions, is that such deductions are not appropriate in the computation of ability to pay and hence understate taxable capacity for those who take them. Arguments in favor of itemized deductions are that they deal with special circumstances, promote social goals, and adjust for the costs of earning income. Many itemized deductions are also very popular politically.

Virginia conforms to federal itemized deductions with minor adjustments. Since the advantages to conformity are considerable in terms of administrative ease and taxpayer convenience, the choices for Virginia include either continuing to allow adjusted federal itemized deductions or not allowing any itemized deductions at all. Some of our options do the former (options 3, 4, and 5) and others the latter (options 1 and 2).

Standard Deduction.--There are a few problems with the current Virginia standard deduction. First, there is a marriage penalty for persons who take the standard deduction. The total standard deduction limits for a married couple are the same as those for a single individual. Second, itemized deductions have risen with inflation and economic growth while the standard deduction has remained fixed, resulting in an increase in the relative advantage of those who itemize. Third, there is a penalty for Virginia taxpayers whose level of

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1/ Numbers in the text refer to our tax reform options. See Table 6.1 and accompanying description of each option.

itemized deductions is between the Virginia standard deduction and the higher federal equivalent--the zero bracket amount (ZBA)--who must take the lower Virginia standard deduction because they take the ZBA at the federal level.

We propose using a standard deduction in the options that also allow itemized deductions (options 3, 4, and 5) and raising it to the level of the federal ZBA--$2,300 for single taxpayers and $3,400 for married couples. This would reduce the marriage penalty, improve the relative advantage of those who take the standard deduction, and eliminate the penalty for those in between the Virginia and federal standard deduction.[1/] Raising the level of the standard deduction would also improve Virginia's poverty level tax relief.

Exemptions.--The level and definition of Virginia's exemptions have been criticized for several reasons. First, they are too low to provide adequate poverty level relief (see poverty floor section below). Second, the equity of age and blindness exemptions is questionable because neither age nor blindness is by itself an indication of need. We propose eliminating these exemptions and have excluded them from our options. This is a relatively minor provision and keeping these exemptions would only slightly reduce revenues. Third, in combination with the graduated rates, the fixed exemptions provide greater relief to high income taxpayers than to those with lower income. This occurs because the value of a fixed exemption increases with a taxpayer's marginal tax rate. To equalize tax relief, we use credits in place of exemptions in all options with graduated rates (options 2, 4, and 5). The value of the credit equals the exemption times the rate of the lowest bracket. When flat rates are used, exemptions provide the same relief as credits and therefore exemptions are used in those options (1 and 3).

Poverty Floor.--The current Virginia income tax does not provide adequate tax relief for households with less than poverty threshold income (see Table 4.1). We suggest raising the minimum taxable level closer to federal poverty thresholds for different size families. For those options with itemized deductions (options 3, 4, and 5), poverty relief is divided between the standard deduction and an exemption (or credit equivalent) of $1,500 per person. For those not allowing personal deductions (options 1 and 2), poverty relief is provided through exemptions (or credit equivalents) alone--$3,200 per taxpayer and spouse and $1,500 per dependent.

Rate Structure.--Virginia currently has a graduated rate structure. Critics of graduated rates consider such rate structures unfair and note that they result in complexities, inefficiencies such as tax shelters, and bracket creep in which inflation pushes taxpayers into higher brackets without any real increase in income. Many call for a flat rate tax. Supporters of a graduated tax system assert that such a tax is both fair and a useful instrument of income redistribution.

Our proposals include graduated and flat rate structures. Two options (1 and 3) have flat rates and three (options 2, 4, and 5) have graduated rates. Of the options with graduated rates, two (options 2 and 4) base their brackets on an approximation of the quartile distribution of taxable income. Taxable income equals AGI in the option without deductions or exemptions (option 2) and we use available data--quartile distribution of AGI by return--to construct the

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1/ However, if Virgina did not conform to any changes in federal ZBAs, this latter problem would reappear.

brackets. In the option with deductions, (option 4) taxable income equals AGI minus deductions, so the above distribution is used with an adjustment for minimum estimated deductions. The remaining graduated rate option (option 5) makes only slight modifications to the existing rate structure and hence, probably has the best chance of enactment. With its mildly graduated brackets it can be viewed as a compromise between those who favor a flat rate and those who support steeply graduated rates.

Rate Level.--In order to analyze the distributional effects of our options, we assume no change in total revenue. In other words, we are solely concerned with differential incidence. The rates used are estimates of those that would yield approximately the same revenue as did the existing tax in 1981.[1/] These estimated rates were generated by the Virginia Tax Department's Individual Income Tax Simulation model using data from the 1981 Virginia Income Tax Master File.[2/] Since each option raises virtually the same revenue as the existing tax, any changes in tax burden can be attributed to differences in the features of each option.

Alternative Tax Options

The various options are described below and listed in Table 6.1. As under the existing system, all taxes are non-negative, i.e., if a credit exceeds tax liability, the taxpayer is not entitled to the difference.

Option 1

Option 1 is a flat rate tax applied over an exempted amount with no standard, itemized, or child care deductions. The rate is 4.4 percent, and an exemption of $3,200 per taxpayer and spouse and $1,500 per dependent is allowed.

Option 2

Option 2 is similar to option 1 except for the use of graduated rates. Again, there are no personal deductions. Credits replace exemptions to equalize tax relief. The taxpayer and spouse credit is set at $83--calculated as $3,200 times the rate of the lowest bracket (2.6 percent). The brackets are set to approximate the quartile distribution of taxable income using the quartile distribution of AGI by return. The rates increase by the same absolute increment (1 percentage point). The rate schedule is:

1/ The hypothetical revenues raised by options 1-5 are within +0.56 percent of the model's estimate of actual revenues raised in 1981 (see Table 6.5). The Joannou proposal differs +1.60 percent from estimated actual revenues.

2/ The Simulation Model was constructed for the Tax Department by the Research Triangle Institute. We would like to thank Craig Forbes of the Virginia Department of Taxation's Research Division for running many versions of our proposed options on the model.

TABLE 6.1

EXISTING TAX AND ALTERNATIVE TAX STRUCTURES

Tax Structure	Exemption/credit	AGI	Standard Deduction	Deductions: Itemized	Deductions: Child Care	Age Credit	Brackets and Rates: Taxable Income	Brackets and Rates: Rate
Existing tax	$600 personal, dependent, age, and blindness exemption.	Includes $400 age deduction	15% of federal AGI or $1,300 but no more than $2,000 for single taxpayers and married filing jointly or combined; 15% of federal AGI or $650 but no more than $1,000 for married filing separately.	Yes	Yes	Yes	$0 to $2,999 $3,000 to $4,999 $5,000 to $11,999 $12,000 and over	2% 3% 5% 5.75%
Option 1	$3,200 taxpayer and spouse exemption and $1,500 dependent exemption. No age or blindness exemption.	No $400 extra age deduction	None	No	No	Yes	All taxable income	4.4%
Option 2	$83 credit per taxpayer and spouse (credit=$3,200 times rate of lowest bracket). $39 credit per dependent (credit =$1,500 times rate of lowest bracket). No age or blindness credit.	No $400 extra age deduction	None	No	No	Yes	$0 to $ 6,999 $7,000 to $13,999 $14,000 to $25,999 $26,000 and over	2.6% 3.6% 4.6% 5.6%
Option 3	$1,500 personal and dependent exemption. No age or blindness exemption.	No $400 extra age deduction	$2,300 for single taxpayers; $1,700 for married filing separately; and $3,400 for married joint or combined.	Yes	Yes	Yes	All taxable income	5.1%
Option 4	$56 credit per person (credit=$1,500 times rate of lowest bracket) No age or blindness credit.	No $400 extra age deduction	$2,300 for single; $1,700 for married separate; $3,400 for married joint or combined.	Yes	Yes	Yes	$0 to $4,999 $5,000 to $11,999 $12,000 to $23,999 $24,000 and over	3.7% 4.7% 5.7% 6.7%
Option 5	$33 credit per person (credit= $1,500 times rate of lowest bracket) No age or blindness credit.	No $400 extra age deduction	$2,300 for single, $1,700 for married separate, $3,400 for married joint or combined.	Yes	Yes	Yes	$0 to $2,999 $3,000 to $4,999 $5,000 to $11,999 $12,000 and over	2.2% 3.2% 5.2% 5.95%
Joannou proposal	$4,500 exemption per taxpayer and spouse. No dependent exemption. No age or blindness exemption.	Includes $400 age deduction[a/]	None	No	No	No	All taxable income	4.75%

a/ The Joannou proposal calls for eliminating this deduction, but the provision was not removed during computer simulation of the proposal.

Taxable Income	Rate
0 to $6,999	2.6%
$7,000 to $13,999	3.6%
$14,000 to $25,999	4.6%
$26,000 and over	5.6%

Option 3

This option has a flat rate and, in contrast to options 1 and 2, allows deductions. Because the tax base is reduced by deductions, the rate (5.1 percent) needs to be higher than in option 1 to raise the same amount of revenue. Provisions for low income relief are divided between the standard deduction and the personal and dependent exemptions. The standard deduction is based on the level of federal ZBAs--$2,300 for single taxpayers, $3,400 for married filing joint or combined returns, and $1,700 for married filing separately. There is a per person exemption of $1,500.

Option 4

This option is similar to option 3 except that it has graduated rates. Also, the per person exemption is replaced by a credit of $56, calculated as $1,500 times the rate of the lowest bracket (3.7 percent). The standard deductions are the same as in option 3. The brackets are based on an approximation of the quartile distribution of taxable income. The brackets are set at the quartile distribution of AGI by return minus $2,000 as an approximation of the minimum deduction rounded to the nearest thousand.1/ The rates increase by the same absolute increment (1 percentage point), resulting in the following rate structure:

Taxable Income	Rate
0 to $4,999	3.7%
$5,000 to $11,999	4.7%
$12,000 to $23,999	5.7%
$24,000 and over	6.7%

Option 5

This option is a modification of the current Virginia income tax. The existing brackets are used and the existing rates are increased by 0.2 percentage points. The following rate structure results:

Taxable Income	Rate
0 to $2,999	2.2%
$3,000 to $4,999	3.2%
$5,000 to $11,999	5.2%
$12,000 and over	5.95%

Standard, itemized, and child care deductions are allowed. Poverty level tax relief is provided through increased standard deductions and credits. The

1/ The lowest deduction possible with this option is the $1,700 standard deduction for married persons filing separately.

standard deductions are equal to federal ZBA amounts. Credits are used instead of exemptions to equalize tax savings. The per person credit is $33, computed as $1,500 times the rate of the lowest bracket (2.2 percent).

Joannou Proposal

This proposal was sponsored by Delegate Johnny S. Joannou in 1981 Virginia House Bill No. 1638. It starts with the existing definition of AGI and applies a flat rate of 4.75 percent. Taxpayer and spouse are each allowed a $4,500 exemption (or deduction as it is called in the bill). There is no exemption for dependents or for age or blindness.[1/] There are no standard, itemized, or child care deductions. It is basically a flat rate tax over an exempted amount of $4,500 per taxpayer and spouse. It is similar to option 1 except for the exemptions.

Analysis

This section examines the distribution of the tax burden under different options, using: 1) average tax liability by AGI class as generated by the computer model, and 2) tax liability of hypothetical taxpayers that we have computed. There are limitations to both approaches. The computer model provides data by AGI class, which obscures differences resulting from family size and other variables. The hypothetical taxpayer approach, on the other hand, is limited by the estimated itemized deductions, since the level of itemized deductions can significantly affect tax liability. The estimated itemized deductions employed in this analysis are those used by the U.S. Advisory Commission on Intergovernmental Relations. Keeping in mind these limitations, data from the computer model and from hypothetical taxpayers are used to analyze the options.

According to both measures all the options, even those with a flat rate, are progressive; that is, the effective rate (tax divided by AGI) rises as income increases (see Tables 6.2 and 6.3). Progressivity of the flat rate taxes results from their use of exemptions, since as income rises, fixed exemptions shelter a smaller percentage of income from tax. While the effective rate rises with income in all options, the rates rise much more in the graduated tax options than in the flat tax options. In Table 6.2 the range of effective rates, i.e., the difference between the effective rates of the highest and lowest AGI classes, is 2.8 percentage points for both flat tax options. This is slightly lower than the range of effective rates for the existing system (3.1 percentage points). The range of effective rates is considerably higher for the graduated rate options--3.8 percentage points in option 2, 4.1 in option 4, and 3.9 in option 5. So, while the flat rate options are progressive, they are not as progressive as those with graduated rates.

The hypothetical taxpayer approach provides a way to compare how well the options provide low income relief. The tax liability for hypothetical taxpayers at the poverty thresholds for different size families is shown in Table 6.4. None of the options provide complete tax relief. However, all the options

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1/ The Joannou proposal calls for eliminating the additional $400 age deduction, but the provision was not removed during computer simulation of the proposal.

TABLE 6.2
AVERAGE TAX LIABILITY AND EFFECTIVE TAX RATE BY VIRGINIA ADJUSTED GROSS INCOME CLASS

	Adjusted Gross Income							
	0 to $9,999	$10,000 to $14,999	$15,000 to $19,999	$20,000 to $24,999	$25,000 to $29,999	$30,000 to $34,999	$35,000 to $39,999	$40,000 to $44,999
Average Tax Liability								
Existing	$74	$284	$495	$702	$899	$1,123	$1,350	$1,565
Option 1	78	307	513	706	918	1,131	1,344	1,554
Option 2	69	270	464	663	868	1,103	1,341	1,601
Option 3	74	310	525	719	923	1,137	1,353	1,547
Option 4	52	257	468	674	884	1,124	1,374	1,615
Option 5	44	261	489	707	924	1,164	1,407	1,638
Effective Tax Rate(%)[a/]								
Existing	1.4%	2.3%	2.8%	3.1%	3.3%	3.5%	3.6%	3.7%
Option 1	1.4	2.5	2.9	3.2	3.4	3.5	3.6	3.7
Option 2	1.3	2.2	2.7	3.0	3.2	3.4	3.6	3.8
Option 3	1.3	2.5	3.0	3.2	3.4	3.5	3.6	3.7
Option 4	1.0	2.1	2.7	3.0	3.2	3.5	3.7	3.8
Option 5	0.8	2.1	2.8	3.2	3.4	3.6	3.8	3.9

	$45,000 to $49,999	$50,000 to $59,999	$60,000 to $69,999	$70,000 to $79,999	$80,000 to $89,999	$90,000 to $99,999	$100,000 and over
Average Tax Liability							
Existing	$1,798	$2,131	$2,575	$3,076	$3,442	$4,135	$8,025
Option 1	1,773	2,073	2,525	2,971	3,366	3,806	7,463
Option 2	1,863	2,232	2,788	3,335	3,870	4,497	9,131
Option 3	1,751	2,055	2,453	2,908	3,219	3,805	7,274
Option 4	1,864	2,252	2,755	3,339	3,778	4,578	9,138
Option 5	1,874	2,226	2,686	3,210	3,592	4,302	8,341
Effective Tax Rate(%)[a/]							
Existing	3.8%	3.9%	4.0%	4.1%	4.1%	4.4%	4.5%
Option 1	3.7	3.8	3.9	4.0	4.0	4.0	4.2
Option 2	3.9	4.1	4.3	4.5	4.6	4.7	5.1
Option 3	3.7	3.8	3.8	3.9	3.8	4.0	4.1
Option 4	3.9	4.2	4.3	4.5	4.5	4.8	5.1
Option 5	4.0	4.1	4.2	4.3	4.2	4.5	4.7

Source: Virginia Department of Taxation, Research Division, 1981 Virginia Individual Income Tax Computer Simulation Model.

a/ Computations by the authors. The effective tax rate is computed as the percentage that tax liability is of adjusted gross income (AGI). The effective rate is found by dividing total tax liability by total AGI for each AGI class.

TABLE 6.3
EFFECTIVE TAX RATES FOR HYPOTHETICAL TAXPAYERS[a]

	Adjusted Gross Income							
	$7,500	$10,000	$15,000	$20,000	$25,000	$50,000	$75,000	$100,000
Individual								
Existing	2.0%	2.7%	2.5%	3.1%	3.6%	4.3%	4.6%	4.8%
Option 1	2.5	3.0	3.5	3.7	3.8	4.1	4.2	4.3
Option 2	1.6	2.1	2.7	3.1	3.4	4.5	4.9	5.1
Option 3	2.5	3.2	3.2	3.5	3.8	4.2	4.3	4.4
Option 4	1.8	2.6	2.7	3.2	3.6	4.7	5.1	5.4
Option 5	1.4	2.4	2.6	3.3	3.7	4.5	4.7	4.9
Joannou Proposal	1.9	2.5	3.3	3.7	3.9	4.3	4.5	4.5
Married couple with no dependents								
Existing	1.6%	2.4%	2.3%	3.0%	3.4%	4.3%	4.5%	4.7%
Option 1	0.6	1.6	2.5	3.0	3.3	3.8	4.0	4.1
Option 2	0.5	1.2	2.1	2.7	3.1	4.3	4.8	5.0
Option 3	0.8	1.8	2.6	3.2	3.5	4.0	4.2	4.3
Option 4	0.5	1.5	2.3	3.0	3.4	4.6	5.0	5.3
Option 5	0.5	1.5	2.4	3.1	3.6	4.4	4.7	4.9
Joannou Proposal	0	0.5	1.9	2.6	3.0	3.9	4.2	4.3
Married couple + 1 dependent								
Existing	1.4%	2.1%	2.1%	2.8%	3.3%	4.2%	4.5%	4.7%
Option 1	0	0.9	2.1	2.7	3.0	3.7	3.9	4.1
Option 2	0	0.9	1.8	2.5	2.9	4.3	4.7	4.9
Option 3	0	1.1	2.1	2.8	3.2	3.8	4.0	4.2
Option 4	0	0.9	1.9	2.7	3.2	4.5	5.0	5.2
Option 5	0	1.1	2.2	3.0	3.5	4.4	4.7	4.8
Joannou Proposal	0	0.5	1.9	2.6	3.0	3.9	4.2	4.3
Married couple + 2 dependents								
Existing	1.1%	1.8%	1.9%	2.6%	3.2%	4.1%	4.4%	4.6%
Option 1	0	0.3	1.6	2.3	2.7	3.6	3.8	4.0
Option 2	0	0.5	1.6	2.3	2.8	4.2	4.6	4.9
Option 3	0	0.3	1.6	2.4	2.8	3.7	3.9	4.1
Option 4	0	0.4	1.5	2.4	3.0	4.4	4.9	5.2
Option 5	0	0.8	2.0	2.8	3.3	4.3	4.6	4.8
Joannou Proposal	0	0.5	1.9	2.6	3.0	3.9	4.2	4.3
Married couple + 4 dependents								
Existing	0.7%	1.2%	1.5%	2.3%	2.9%	4.0%	4.3%	4.6%
Option 1	0	0	0.8	1.7	2.2	3.3	3.7	3.9
Option 2	0	0	1.1	1.9	2.5	4.0	4.5	4.8
Option 3	0	0	0.6	1.6	2.2	3.4	3.7	4.0
Option 4	0	0	0.8	1.8	2.5	4.2	4.7	5.1
Option 5	0	0.2	1.5	2.5	3.1	4.2	4.5	4.7
Joannou Proposal	0	0.5	1.9	2.6	3.0	3.9	4.2	4.3

Source: Computations by the authors based on Table 6.6.

a/ Effective rate is computed as the percentage that tax liability is of adjusted gross income (AGI). In computing tax liability it was assumed that all income was from wages and salaries and earned by one spouse. The following estimated itemized deductions were assumed: $15,000 AGI—$4,250 itemized deductions; $20,000 AGI--$4,700; $25,000 AGI--$5,050; $50,000 AGI--$7,850; $75,000 AGI—$10,950; and $100,000 AGI--$13,165. These estimates are based on those contained in ACIR, Significant Features of Fiscal Federalism, 1981-82, 1983, p. 58, for a family of 4. For AGI of $7,500 and $10,000 the standard deduction was used.

TABLE 6.4

- TAX LIABILITY FOR HYPOTHETICAL TAXPAYERS AT POVERTY THRESHOLDS

Number in Family	AGI=Poverty Threshold[b/]	Tax Liability[a/]						
		Existing	Option 1	Option 2	Option 3	Option 4	Option 5	Joannou Proposal
1	$ 4,900	$ 60	$75	$ 44	$56	$ 40	$ 24	$ 19
2	6,280	83	0	0	0	0	0	0
3	7,690	108	0	2	0	0	8	0
4	9,860	169	20	41	23	30	74	41
5	11,680	216	34	67	41	59	136	127
6	13,210	251	36	84	41	75	182	200
7	14,980	309	48	118	55	102	241	284

Source: Computations by the authors.

a/ In computing tax liability it was assumed that all income was from wages and salaries and earned by one spouse. The family was assumed to be a married couple with dependents. The standard deduction was taken where applicable.

b/ Poverty thresholds are found in U.S. Department of Commerce, Bureau of the Census, "Estimated Weighted Average Poverty Thresholds in 1982 (January 24, 1983)," memo provided by Carol Fendler, Bureau of the Census, February 1, 1983.

impose a much lower tax burden on those with poverty level income than the current system, with the exception of single taxpayers under option 1.

Table 6.5 lists by AGI class the differences in tax liability between each option and the existing system as calculated by the computer model. The table clearly indicates that the flat rate proposals (options 1,3, and Joannou) raise taxes for middle income taxpayers while reducing taxes for those with higher incomes, although the Joannou proposal lowers taxes only for the two highest AGI classes.

On the other hand, the graduated tax proposals (options 2, 4, and 5) reduce the burden of lower income taxpayers, while increasing it for those with higher incomes. Options 2 and 4 reduce the burden of many AGI classes while raising the tax burden close to 14 percent for the top AGI class. Option 5 significantly reduces the burden of a few bottom AGI classes, while only moderately raising the tax burden of the other income groups.

All the options, except option 1, reduce the burden of the lowest AGI class, although the graduated rate options provide the greatest relief. Of the flat rate options, the Joannou proposal helps the bottom AGI class the most. It does so because the large exemption has the effect of removing many people from the tax rolls entirely. In contrast, option 5 provides more tax relief for the bottom AGI class and keeps more low income people as taxpayers, while imposing only a minimal burden on them. This is accomplished through its lower exemptions, mildly graduated brackets, and low bottom rates.

The impact of the options on the distribution of tax burden according to family size is illustrated by examining the tax liability and effective rates of hypothetical taxpayers of different size families (see Tables 6.3 and 6.6). A review of these tables shows that, relative to the current system, the flat rate options 1 and 3 increase the burden of low and moderate income single taxpayers relative to the current system. It appears that their increased exemptions and standard deductions are not enough to make up for their higher rates. Married couples earning approximately $15,000 to $25,000 would also pay more tax. Generally, all other hypothetical taxpayers have a reduced burden under the flat tax options. The Joannou proposal increases the tax burden for middle income individuals and large families and decreases the burden for all others. The graduated rate options (2, 4, and 5) appear to reduce the tax burden for lower income taxpayers and raise it for upper income taxpayers across all size families.

In sum, the distribution of the tax burden varies under each of the options. In general, the flat rate proposals (options 1, 3, and Joannou) penalize middle income taxpayers while the graduated rate options (2, 4, and 5) increase the burden on upper income groups. All the options, for the most part, improve the level of poverty tax relief over that of the existing system.

TABLE 6.5

DIFFERENCE IN TAX LIABILITY BETWEEN EACH OPTION AND EXISTING SYSTEM BY AGI CLASS

AGI Class	Option 1	Option 2	Option 3	Option 4	Option 5	Joannou Proposal
Total	0.37%	0.52%	0.14%	0.14%	0.56%	1.60%
0 to $9,999	4.79	-7.60	-0.62	-29.52	-40.10	-16.03
$10,000 to $14,999	8.07	-4.93	9.13	-9.56	-7.93	6.50
$15,000 to $19,999	3.75	-6.32	6.04	-5.39	-1.16	3.33
$20,000 to $24,999	0.57	-5.63	2.35	-4.08	0.72	1.59
$25,000 to $29,999	2.15	-3.51	2.63	-1.70	2.76	3.05
$30,000 to $34,999	0.67	-1.78	1.18	0.01	3.61	2.44
$35,000 to $39,999	-0.50	-0.68	0.18	1.78	4.21	1.91
$40,000 to $44,999	-0.72	2.29	-1.19	3.20	4.63	2.65
$45,000 to $49,999	-1.38	3.64	-2.61	3.67	4.22	2.81
$50,000 to $59,999	-2.75	4.73	-3.60	5.68	4.46	1.54
$60,000 to $69,999	-1.92	8.29	-4.71	7.00	4.32	2.93
$70,000 to $79,999	-3.44	8.41	-5.48	8.55	4.35	1.70
$80,000 to $89,999	-2.21	12.44	-6.49	9.77	4.37	3.49
$90,000 to $99,999	-7.96	8.76	-7.99	10.71	4.04	-1.91
$100,000 and over	-7.01	13.78	-9.36	13.87	3.93	-0.39

Source: Virginia Department of Taxation, Research Division, 1981 Virginia Individual Income Tax Computer Simulation Model.

TABLE 6.6
TAX LIABILITY FOR HYPOTHETICAL TAXPAYERS[a]

	Adjusted Gross Income							
	$7,500	$10,000	$15,000	$20,000	$25,000	$50,000	$75,000	$100,000
Individual								
Existing	$150	$265	$378	$625	$893	$2,169	$3,428	$4,739
Option 1	189	299	519	739	959	2,059	3,159	4,259
Option 2	117	207	397	627	857	2,247	3,647	5,047
Option 3	189	316	472	704	941	2,073	3,190	4,352
Option 4	138	256	399	646	911	2,358	3,825	5,352
Option 5	107	237	396	657	934	2,255	3,558	4,914
Joannou Proposal	143	261	499	736	974	2,161	3,349	4,536
Married couple with no dependents								
Existing	120	235	348	591	858	2,135	3,394	4,704
Option 1	48	158	378	598	818	1,918	3,018	4,118
Option 2	34	124	314	544	774	2,164	3,564	4,964
Option 3	56	184	395	627	864	1,997	3,114	4,276
Option 4	40	148	343	590	855	2,302	3,769	5,296
Option 5	35	147	363	624	901	2,222	3,525	4,881
Joannou Proposal	0	48	285	523	760	1,948	3,135	4,323
Married couple + 1 dependent								
Existing	102	205	318	556	824	2,100	3,359	4,670
Option 1	0	92	312	532	752	1,852	2,952	4,052
Option 2	0	85	275	505	735	2,125	3,525	4,925
Option 3	0	107	319	551	788	1,920	3,037	4,199
Option 4	0	92	287	534	799	2,246	3,713	5,240
Option 5	2	114	330	591	868	2,189	3,492	4,848
Joannou Proposal	0	48	285	523	760	1,948	3,135	4,323
Married couple + 2 dependents								
Existing	84	175	288	522	789	2,066	3,325	4,635
Option 1	0	26	246	466	686	1,786	2,886	3,986
Option 2	0	46	236	466	696	2,086	3,486	4,886
Option 3	0	31	242	474	711	1,844	2,961	4,123
Option 4	0	36	231	478	743	2,190	3,657	5,184
Option 5	0	81	297	558	835	2,156	3,459	4,815
Joannou Proposal	0	48	285	523	760	1,948	3,135	4,323
Married couple + 4 dependents								
Existing	52	117	228	455	720	1,997	3,256	4,566
Option 1	0	0	114	334	554	1,654	2,754	3,854
Option 2	0	0	158	388	618	2,008	3,408	4,808
Option 3	0	0	89	321	558	1,691	2,808	3,970
Option 4	0	0	119	366	631	2,078	3,545	5,072
Option 5	0	15	231	492	769	2,090	3,393	4,749
Joannou Proposal	0	48	285	523	760	1,948	3,135	4,323

Source: Computations by the authors.

a/ In computing tax liability it was assumed that all income was from wages and salaries and earned by one spouse. The following estimated itemized deductions were assumed: $15,000 AGI—$4,250 itemized deductions; $20,000 AGI--$4,700; $25,000 AGI--$5,050; $50,000 AGI—$7,850; $75,000 AGI—$10,950; and $100,000 AGI—$13,165. These estimates are based on those contained in ACIR, Significant Features of Fiscal Federalism, 1981-82, 1983, p. 58, for a family of 4. For AGI of $7,500 and $10,000 the standard deduction was used.

Other Provisions

This chapter has presented a number of reforms that were incorporated into computer model simulations of the Virginia income tax. In this section a few additional suggestions will be summarized. 1) All fixed dollar amounts could be indexed to avoid the distortions caused by inflation. Indexation would include all exemptions and credits and the brackets in options 2, 4, and 5. The maximum standard deduction in options 3, 4, and 5 also should be indexed or conformed to the federal ZBAs, which will be indexed. 2) The tax base could be broadened by taxing a percentage of the federal alternative minimum tax on tax preference items. 3) The age credit could be improved by raising or eliminating the $12,000 income constraint. This constraint results in considerable complexity and causes inequities among upper income taxpayers with different sources of income. 4) If a local income tax were desired, it could be implemented with a piggyback tax on the state income tax. In comparison to a local payroll tax, this would reduce administrative costs and complexities for the taxpayer and the locality. 5) Income averaging provisions could be included with options 2, 4, and 5 so that taxpayers whose income is "bunched" in one year would not be pushed into higher brackets.

Conclusions

The long history of the Virginia individual income tax shows how the present institution has gradually taken shape. Many of today's features that are widely accepted (state administration and withholding, for example) were formerly controversial issues. A number of tax provisions have remained unchanged for a long time. Today's tax brackets are those of 1926 with a bracket tacked on in 1972. Exemptions and the standard deduction have not been altered since the early 1970s. The stability of the tax structure has occurred despite many changes in the economy and the rapid inflation of the last decade. Bracket creep and an increased burden on low income taxpayers have resulted from the failure to adjust the tax structure for these changes.

Rather than develop a single solution to the problems with the current tax, we have developed several options to aid policymakers. Rates selected for each option are those needed to raise the existing level of income tax revenues. As noted, this differential incidence approach is used so that changes in the distribution of the tax burden can be compared among the options and the existing system. If a decision to raise revenue is made, we suggest raising the rates of our options rather than modifying other features that were designed to promote equity, efficiency, and simplicity. That is not to deny that modifications could be made to our proposals. The options are merely frameworks to illustrate methods and consequences of tax reform. Some variations, such as adding back the age and blindness exemptions, could easily be implemented without significantly altering the proposals. It is also important to recall that any increase in Virginia's income tax liability on taxpayers who itemize would be partially offset by the deductibility of state income taxes in the computation of the federal income tax.

The need for increased state revenues may focus attention on the Virginia income tax. We hope that any search for revenues will be viewed as an opportunity to implement tax reforms, such as those presented here.

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